2007

Fiction, Form, and Substance in Subchapter K: Taxing Partnership Mergers, Divisions, and Incorporations

Heather M. Field
UC Hastings College of the Law, fieldh@uchastings.edu

Fiction, Form, and Substance in Subchapter K: Taxing Partnership Mergers, Divisions, and Incorporations

HEATHER M. FIELD*

TABLE OF CONTENTS

* Associate Professor, University of California, Hastings College of the Law. The author wishes to thank Daniel Lathrope, Martin McMahon, Michael Oberst, Reuven Avi-Yonah, and Laurence Stein for their comments and suggestions.

I. INTRODUCTION

Most corporate and tax lawyers know that a single economic transaction often can be effectuated through a variety of different structures. Once a structure is selected, query how the tax consequences of the economic transaction should be determined. Should the tax consequences be based on the formal legal steps chosen to accomplish the transaction (the "form" of the transaction)? Should the tax consequences depend on the "substance" of the transaction—a recast of the deal reflecting the "non-tax economic relationships between the parties created, and commercial goals achieved, by virtue of the transaction[?]"[1] Or should the tax consequences be based on a "fiction"—a set of hypothetical steps that is deemed to, but does not actually, occur, and that is not merely a substantive recast of the transaction?[2] Whether to choose form or substance is a common

1. Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 TAX LAW. 457, 457 n.2 (1999).

2. In an attempt to define "legal fiction," one commentator has explained:

> [Fiction's] true nature remains difficult to state with clarity. The legal fiction is an elusive concept because by design it must blend into its surroundings; it

question in tax law,[3] but this question rarely offers a third possible answer—fiction. Perhaps this reflects a desire for tax analysis to be grounded in reality, either economic reality in the case of substance, or legal reality in the case of form. Or perhaps fiction can be viewed merely as a subset of substance, since analyzing the substance of a transaction requires that the tax consequences be determined on the basis of hypothetical steps that reflect the true nature of the transaction and that are deemed to occur. However, a fiction-based analysis can be both legitimate and more than just a mechanism of substantive analysis.[4] In fact, the use of fiction already pervades the tax law. One commentator explained:

> Tax law is riddled with legal fictions. For example, the law "attributes" ownership of property to one person when it is actually owned by another. It "constructs" non-existent transfers of money between persons. It "deems"

> must adapt to changing circumstances. On a philosophical level, the legal fiction is the expression of a relation. In legal theory it may be described as a metaphor. On a more pragmatic level, it is a falsehood deemed to be true for limited purposes. But none of these phrases convey a concrete image. The legal fiction is a form that draws its substance from the body of law in which it is employed.

John A. Miller, *Liars Should Have Good Memories: Legal Fictions and the Tax Code*, 64 U. COLO. L. REV. 1, 5 (1993) (footnotes omitted).

3. The existing discussions in the literature about substance and form serve as a backdrop for this Article's discussion about formulating a coherent approach to the application of form and fictions. *See generally, e.g.*, Sheldon I. Banoff, *Mr. Popeil Gets 'Reel' About Conversions of Legal Entities: The Pocket Fisherman Flycasts for "Form" but Snags on "Substance,"* 75 TAXES 887 (1997); William F. Nelson, *The Limits of Literalism: The Effects of Substance Over Form, Clear Reflection and Business Purpose Considerations On the Proper Interpretation of Subchapter K*, 73 TAXES 641 (1995); Steinberg, *supra* note 1; Stephen G. Utz, *Partnership Taxation in Transition: Of Form, Substance, and Economic Risk*, 43 TAX LAW. 693 (1990); Joseph Isenbergh, *Musings on Form and Substance in Taxation*, 49 U. CHI. L. REV. 859 (1982) (book review). However, a detailed discussion of substance over form principles is outside the scope of this Article. This Article's focus is not on whether and when to use substance rather than form or form rather than substance, largely because, as discussed in greater detail below, the varieties of each transaction discussed herein are substantively equivalent. Hence, trying to analyze such a transaction in accordance with its substance is insufficient to determine how it should be taxed.

4. See Miller, *supra* note 2, for a theoretical discussion of legal fiction as a phenomenon of the tax law, providing, among other things, a review of some of the relevant literature on the role of fictions in legal analysis. This Article, while informed by such theoretical discussions, takes a more application-oriented approach and discusses fiction as it is used and should be used in the analysis of partnership mergers, divisions, and incorporations.

property held for a different period of time from that for which it was actually held. And tax law treats transfers of property "as if" they never occurred.[5]

Fictions can be used in many ways in tax law, from implementing analogies that apply existing law to new facts, to making incremental changes in the law over time.[6] Moreover, as this Article will demonstrate, fictions[7] can be particularly helpful when transactions are undertaken without a clear form, when the substance of a transaction can be effectuated through multiple and equally plausible structures, or when there is a desire to permit flexibility in the tax characterization of a particular entity or event. However, throughout the Tax Code,[8] and in Subchapter K in particular,[9] balancing the use of fictions with the use of substance and form in the tax analysis of transactions remains difficult.[10]

This Article focuses on how substance, form, and fiction should be used in the analysis of the tax consequences of partnership mergers, divisions, and incorporations. Part II of this Article discusses various forms of partnership mergers, divisions, and incorporations, explains the tax constructs that are used for analyzing these forms,[11] and demonstrates that the analysis of these forms under current authority can lead to disparate tax treatment of substantively equivalent transactions. The constructs, as they are presently applied, incorporate an inconsistent adherence to form and a limited use of fictions, and Part III of this Article analyzes the policy implications of this part-form, part-fiction

5. Miller, *supra* note 2, at 2–3 (footnotes omitted).

6. *See id.* at 5–6, 26.

7. In an effort to distinguish between hypothetical steps invented solely to most accurately reflect the substance of a transaction (as a substantive recast) from hypothetical steps that are pure fabrication, the remainder of this Article's use of the term "fiction" will refer only to the latter unless specifically stated. The former will be referred to as "substance."

8. Unless otherwise stated, all "section" references and references to the "Code" herein refer to the Internal Revenue Code of 1986, as amended, and the Treasury regulations promulgated thereunder.

9. Subchapter K is comprised of Sections 701 through 777 of the Code and generally sets forth the rules dealing with the federal income taxation of partners and partnerships.

10. *See, e.g.*, John S. Pennell & Philip F. Postlewaite, *When Hypothetical Transactions Have Real Results—New Prop. Regs. for Subchapter K*, 88 J. TAX'N 262 (1998) (discussing the rules regarding special adjustments to basis); Joseph A. Snoe, *Economic Reality or Regulatory Game Playing?: The Too Many Fictions of the § 752 Liability Allocation Regulations*, 24 SETON HALL L. REV. 1887 (1994) (discussing the use of fictions in the analysis of the rules regarding the treatment of partnership liabilities).

11. By "construct," I mean the set of transactional steps, whether actual or hypothetical, that are respected for purposes of determining the tax consequences of a transaction. As used herein, the term "construct" does not indicate a judgment about whether the tax analysis is based on the actual form of the transaction or whether the tax analysis is based on a fiction.

approach. Specifically, Part III concludes that the existing tax rules for the analysis of partnership mergers, divisions, and incorporations distort parties' incentives about whether and how to undertake transactions. This distortion undermines several well-accepted tax policy goals such as neutrality and efficiency, without materially advancing other considerations such as simplicity and administrability. To address these policy concerns and to rationalize the use of form and fiction in the tax analysis of partnership mergers, divisions, and incorporations, Part IV proposes that, regardless of the actual form of the transaction, parties should be able to elect which one of three fictions will apply for purposes of analyzing the tax consequences of partnership mergers, divisions, and incorporations.

II. ANALYZING THE TAX CONSEQUENCES OF PARTNERSHIP MERGERS, DIVISIONS, AND INCORPORATIONS

As with many transactions, partnership mergers, divisions, and incorporations can be effectuated through various forms under the applicable state law.[12] In order to determine the tax consequences of these transaction forms, the IRS generally uses the "assets-up," "assets-over," and "interests-over" constructs. The details of how these constructs apply to partnership mergers, divisions, and incorporations are set forth in Treasury Regulation § 1.708-1(c), Treasury Regulation § 1.708-1(d),[13] and Revenue Ruling 84-111,[14] respectively, and are discussed below.[15]

---

12. For example, in order to merge, the merged partnership and the surviving partnership can undertake a statutory merger. *See, e.g.*, DEL. CODE ANN. tit. 6, §15-902 (2007) (providing for the statutory merger of two partnerships). Alternatively, the partnerships could undertake various transfers that have the effect of combining the businesses of two partnerships. For example, (a) the merged partnership can transfer its assets to the surviving partnership in exchange for interests in the surviving partnership and then liquidate; (b) the merged partnership can transfer its assets up to its partners and then the partners can contribute the assets to the surviving partnership in exchange for interests in the surviving partnership; (c) the partners in the merged partnership can transfer all of their interests in the merged partnership to the surviving partnership; or (d) some combination of the foregoing can be undertaken, such as transferring some assets directly from the merged partnership to the surviving partnership and transferring some assets up to the partners of the merged partnership.

13. The current versions of Treas. Reg. § 1.708-1(c) and -1(d) were proposed in 2000 by Partnership Mergers and Divisions, 65 Fed. Reg. 1572 (proposed Jan. 11, 2000), and finalized in 2001 by T.D. 8925, 2001-1 C.B. 496. For ease of discussion, the regulations proposed in the 2000 Federal Register will often be referred to as the "Proposed Section 708 Regulations," the regulations finalized in the 2001 Treasury Decision will often be referred to as the "Final Section 708 Regulations," and reference

A. Partnership Mergers[16]

1. General Rules

In applying the various constructs to a partnership merger, the Code and regulations first determine whether the combined partnership (the "resulting partnership") is a continuation of either of the merging

---

to the "Section 708 Regulations" will denote the Proposed Section 708 Regulations and Final Section 708 Regulations together.

Prior to the promulgation of the Section 708 Regulations, partnership mergers were generally analyzed under the assets-over construct. *See, e.g.*, Rev. Rul. 68-289, 1968-1 C.B. 314. However, the Service did not employ a consistent approach to partnership divisions prior to the promulgation of Section 708 Regulations. The IRS respected the assets-up approach taken in I.R.S. Priv. Ltr. Rul. 89-45-069 (Aug. 17, 1989), respected the assets-over approach taken in I.R.S. Priv. Ltr. Rul 94-37-007 (June 10, 1994), and recast an attempted assets-over transaction as an assets-up division in I.R.S. Priv. Ltr. Rul. 93-50-035 (Sept. 22, 1993), in each case without articulating a clear rationale for the choice of construct.

14. Rev. Rul. 84-111, 1984-2 C.B. 88. Before Revenue Ruling 84-111, Revenue Ruling 70-239 provided that all forms of incorporations were treated pursuant to the assets-over construct. Rev. Rul. 70-239, 1970-1 C.B. 74.

15. This Article assumes that the Section 707 regulations regarding disguised sales do not change the analysis set forth herein for mergers and divisions and assumes that the final regulations regarding disguised sales will coordinate with the application of the Final Section 708 Regulations. *See generally* Richard M. Lipton, *Controversial Prop. Regs. on Disguised Sales of Partnership Interests—IRS Jumps into the Deep End*, 102 J. TAX'N 71, 76 & n.28 (2005) (discussing the possibility of interaction between the regulations regarding partnership mergers and divisions and the proposed regulations regarding disguised sales).

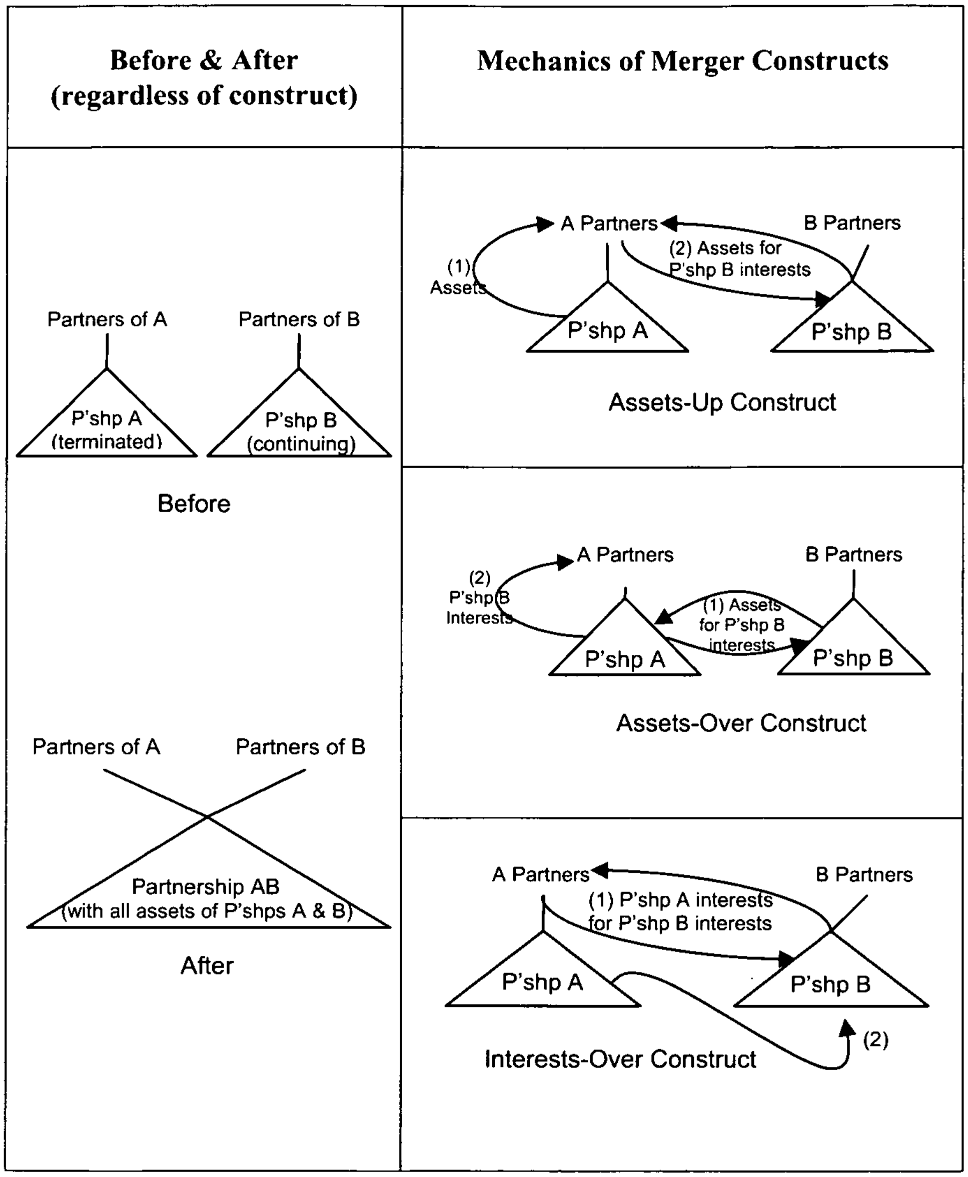
16. Neither the Code nor the Treasury Regulations actually defines whether a transaction constitutes a merger of partnerships. I.R.C. § 708(b)(2)(A) (2000); Treas. Reg. § 1.708-1(c) (as amended in 2002). In connection with the promulgation of the Final Section 708 Regulations, the IRS considered including, but explicitly decided not to provide, a definition of the term "merger." T.D. 8925, 2001-1 C.B. 496. However, the IRS has generally treated the combination of two or more partnerships (or the businesses of such partnerships) into a single partnership as a merger for purposes of Section 708, regardless of the form or state law nomenclature for the transaction. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2003-39-031 (June 24, 2003) (applying the partnership merger rules to the consolidation of six partnerships into a single LLC); 1 WILLIAM S. MCKEE ET AL., FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS ¶ 12.06[1] n.199 (3d ed. 2004) (collecting examples of transactions that the IRS treated as mergers prior to the promulgation of the Final Section 708 Regulations). This Article adopts this approach, treating the amalgamation of multiple partnerships as a merger for purposes of Section 708. Further, although a merger can involve many partnerships, for simplicity all partnership mergers discussed in this Article are assumed to be mergers of only two partnerships, unless otherwise stated. As an aside, the failure of the IRS to provide a definition has raised the ire of some commentators, who argue that this omission results in an unfair and unnecessary uncertainty. *See, e.g.*, Barksdale Hortenstine et al., *Final Partnership Merger and Division Regulations—Analysis, Commentary and Examples, in* TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2006, at 293, 306–07 (PLI Tax Law & Estate Planning, Course Handbook Series No. 702, 2006), *available at* WL 702 PLI/Tax 293.

partnerships.[17] The answer to this question depends on the substance of the transaction; the Code and regulations look specifically at the ownership or asset composition of the resulting partnership without regard to which entity is formally the surviving partnership under state law. The resulting partnership is considered a continuation of a merging partnership if the partners of that merging partnership own "more than 50 percent of the capital and profits of the resulting partnership."[18] If the partners of more than one of the merging partnerships own more than 50% of the capital and profits of the resulting partnership,[19] then the resulting partnership is "considered [a] continuation solely of that partnership which is credited with the contribution of assets having the greatest fair market value (net of liabilities) to the resulting partnership."[20]

Once it has been determined which merging partnership is treated as continuing and which merging partnership is treated as terminated,[21] the partnership merger constructs are applied. The Treasury regulations' two basic constructs for partnership mergers are assets-up and assets-over. Under the assets-up construct, the terminated partnership is treated as distributing its assets up to its partners in liquidation, and then the partners of the terminated partnership are treated as contributing the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.[22] Under the assets-over construct, the terminated partnership is treated as contributing its assets and liabilities over to the resulting partnership in exchange for interests in the resulting partnership, and then the terminated partnership is treated as making a liquidating distribution to its partners of the interests in the resulting partnership.[23] The interests-over construct, in which the partners in the terminated partnership contribute all of their interests in the terminated partnership over to the resulting partnership in exchange for interests in the resulting

17. I.R.C. § 708(b)(2)(A) (2000); Treas. Reg. § 1.708-1(c)(1) (as amended in 2002).
18. Treas. Reg. § 1.708-1(c)(1) (as amended in 2002).
19. This could occur, for example, if some partners own interests in both merging partnerships.
20. § 1.708-1(c)(1). If members of no merging partnership own more than 50% of the capital and profits of the resulting partnership, the resulting partnership is treated as a new partnership and not as a continuation of any prior partnership. *Id.*
21. Any partnership that is not treated as "continuing" is considered to be terminated. *Id.*
22. *Id.* § 1.708-1(c)(3)(ii).
23. *Id.* § 1.708-1(c)(3)(i).

partnership, is not respected under the Treasury regulations.[24] Note that all three constructs lead to the same substantive result:



24. *Id.* § 1.708-1(c)(4). If the interests-over construct was respected, the partners of the terminated partnership would be treated for tax purposes as transferring interests in the terminated partnership to the resulting partnership, and the resulting partnership would be treated as receiving *assets*. Partnership Mergers and Divisions, 65 Fed. Reg. 1572 (proposed Jan. 11, 2000); Rev. Rul. 84-111, 1984-2 C.B. 88; McCauslen v. Comm'r, 45 T.C. 588 (1966); *see infra* note 51.

The Treasury regulations also provide for a variation on the assets-over approach to address the situation where some partners want to sell all or part of their interests. Under the "buyout" rule, a partner in the terminated partnership can sell its interest in the terminated partnership to the continuing partnership immediately before the assets-over transaction.[25] Subject to the satisfaction of certain conditions, the Service will respect this transfer as a sale of interests governed by Section 741 of the Code.[26]

All of these rules and constructs operate against the backdrop of an anti-abuse rule. Pursuant to the anti-abuse rule, if a merger is part of a larger series of transactions, the Service can disregard the form of the merger altogether and "recast the larger series of transactions in accordance with their substance."[27]

2. *Application of the Assets-Up Construct*

The assets-up construct generally adheres to form, in that it only applies if the terminated partnership actually transfers its assets up to the partners "in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets."[28] The preamble to the Final Section 708 Regulations explains that, in order to accomplish this transfer, it is insufficient for partners merely to "assign their rights to receive title to the assets in liquidation of the partnership, or direct the partnership to transfer title to the assets to the resulting partnership."[29] Further, although the preamble states that "[f]or *most* types of assets, this [transfer of assets] will not require the actual transfer and recording of a deed or certificate of title,"[30] it is clear that the transfer of title and recording of a deed will, in fact, be required in order to transfer certain assets.

Notwithstanding the regulations' general adherence to form and applicable local law, the assets-up construct contains fictional elements as well. For example, the preamble to the Final Section 708 Regulations and the

25. Treas. Reg. § 1.708-1(c)(4) (as amended in 2002).
26. *Id.* § 1.708-1(c)(4), -1(c)(5) (ex. 5). Although the merger regulations do not respect the interests-over construct, the buyout rule is an "interests-over"-type transaction in that the transfer is respected as a transfer of interests.
27. *Id.* § 1.708-1(c)(6).
28. *Id.* § 1.708-1(c)(3)(ii).
29. T.D. 8925, 2001-1 C.B. 496, 497.
30. *Id.* (emphasis added).

regulations themselves indicate that the transfer of an asset to the partners will be respected even if the partners generally could not own the asset outside the partnership.[31] Further, despite the requirement that the terminated partnership actually transfer the assets to the partners, the partners are not actually required to assume the liabilities of the partnership in order for the assets-up form to be respected.[32]

3. Application of the Assets-Over Construct

Any partnership merger that is not structured in a way that qualifies for assets-up treatment will be treated as an assets-over transaction.[33] Hence, the assets-over construct will apply not only to transactions actually taken in an assets-over form, but also to any formless partnership merger that occurs under a state statute, any partnership merger that is effectuated in an interests-over form, and any partnership merger that otherwise fails to qualify as an assets-up transaction.

Because the assets-over construct applies to such a wide variety of transactions, many of which do not involve the transfer of assets at all, the transfers that are deemed to occur in a partnership merger may be entirely fictional and markedly different from the transfers that actually occur. This possible fictional result is magnified because, as discussed above in Part II.A.1, the partnership that is treated as continuing for tax purposes, and thus treated as receiving the transferred assets, may cease to exist for state law purposes.

31. *Id.*; Treas. Reg. § 1.708-1(c)(5) (ex. 3) (as amended in 2002). To illustrate this point, the Service cites goodwill (and specifically, the undivided interest in business goodwill that a partner might receive as part of an assets-up transaction) as the type of asset that might raise this problem. § 1.708-1(c)(5) (ex. 3); T.D. 8925, 2001-1 C.B. 496.

32. T.D. 8925, 2001-1 C.B. 496; *see infra* notes 85–86 and accompanying text (discussing the Service's explanation for this treatment of liabilities).

33. Treas. Reg. § 1.708-1(c)(3)(i) (as amended in 2002).

B. Partnership Divisions[34]

1. General Rules

The tax treatment of partnership divisions is quite similar to the tax treatment of partnership mergers. In order to understand how the various constructs apply to a partnership division, one must first determine whether any of the post-division local law partnerships (the "resulting partnerships") are a continuation of the pre-division local law partnership (the "prior partnership"), and, if so, which continuing partnership (if any) is treated as being divided for tax purposes (the "divided partnership").[35] As with partnership mergers, the Code and regulations look to the substance of the division in order to answer these questions. A resulting partnership is considered a continuation of the prior partnership "[i]f the members of the resulting partnership or partnerships had an interest of more than 50 percent in the capital and profits of the prior partnership."[36] If there is only one continuing partnership, that

34. As with mergers, the IRS considered including a definition of partnership "division" in the Final Section 708 Regulations but ultimately provided little guidance. T.D. 8925, 2001-1 C.B. 496; *see also supra* note 16. However, the Service did explain that "[t]o have a division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction." T.D. 8925, 2001-1 C.B. 496, 499; Treas. Reg. § 1.708-1(d)(4)(iv) (as amended in 2002). In the absence of a full definition of the term "division," the IRS has generally treated the separation of one partnership into two or more partnerships (each of which has at least two members that were members of the prior partnership) as a division for purposes of Section 708, regardless of the form or state law nomenclature for the transaction. *See, e.g.*, I.R.S. Priv. Ltr. Rul. 2002-23-045 (Mar. 3, 2002) (applying the partnership division rules to the separation of a single LLC into two LLCs). This Article adopts this approach. Further, although a division can involve the separation of one partnership into many partnerships, for simplicity, all partnership divisions discussed in this Article are assumed to be divisions of one partnership into only two partnerships, unless otherwise stated.

35. I.R.S. § 708(b)(2)(B) (2000); Treas. Reg. § 1.708-1(d)(1) (as amended in 2002). The regulations employ very specific terminology in describing the tax consequences of divisions. The "prior partnership" and the "resulting partnerships" both refer to partnerships actually existing under local law; the "prior partnership" is the partnership that exists under local law before the division, and the "resulting partnerships" are the partnerships that exist under local law after the division. Treas. Reg. § 1.708-1(d)(4)(ii), (iv) (as amended in 2002). The "divided partnership" and the "recipient partnership" are tax fictions used for purposes of determining the tax consequences of the division. The "divided partnership" is the partnership that is treated for tax purposes as transferring assets and liabilities to the recipient partnership in the division, while the "recipient partnership" is the partnership that is treated for tax purposes as receiving assets and liabilities from the divided partnership in the division. *Id.* § 1.708-1(d)(4)(i), (iii).

36. Treas. Reg. § 1.708-1(d)(1).

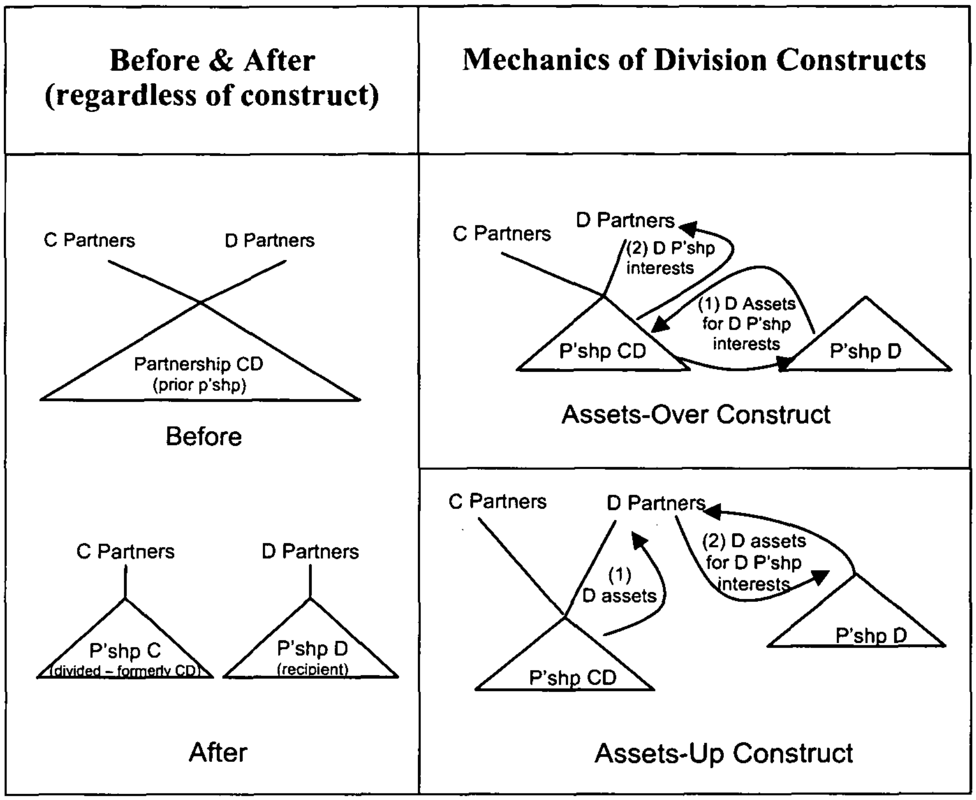
partnership is treated as the divided partnership. If there is more than one continuing partnership, the regulations have a series of "tiebreak" rules for determining which continuing partnership will be the divided partnership.[37] These rules apply regardless of whether the continuing or divided partnerships existed under state law prior to the division.

Once the divided partnership, if any, has been identified, the partnership division constructs are applied. As with partnership mergers, the Treasury Regulations provide two basic constructs for analyzing partnership divisions—the assets-up construct and the assets-over construct; there is no interests-over formulation for partnership divisions. Under the assets-up construct, the divided partnership is treated as distributing certain assets to some or all of its partners in partial or complete liquidation of their interests, and then the partners are treated as contributing all of the distributed assets into the new recipient partnership in exchange for interests in the new recipient partnership.[38] Under the assets-over construct, the divided partnership is treated as contributing certain assets to the recipient partnership in exchange for interests in the recipient partnership, and then the divided partnership is treated as distributing the interests in the recipient partnership to some or all of the divided partnership's partners in partial or complete liquidation.[39] Note that both the assets-up and the assets-over constructs lead to the same substantive result:

37. *Id.* § 1.708-1(d)(4)(i). If there are multiple continuing partnerships, the tiebreak rules provide that if one of the continuing partnerships actually transferred assets and liabilities in the division, that continuing partnership is the divided partnership. Otherwise, the continuing partnership with assets having the greatest net fair market value is treated as the divided partnership. *Id.*

38. *Id.* § 1.708-1(d)(3)(ii)(A). If none of the resulting partnerships are continuations of the prior partnerships (and hence there is no divided partnership), then the assets-up construct works basically the same way, except that it is the *prior partnership* (and not the divided partnership, since there is none) that will be treated as distributing assets, and the partners will be treated as contributing the distributed assets into *resulting partnerships* (if there is no divided partnership, there can be no recipient partnership).

39. *Id.* § 1.708-1(d)(3)(i)(A). If none of the resulting partnerships are continuations of the prior partnerships, then the assets-over construct works in a similar manner, except that the *prior partnership* will be treated as contributing *all* of its assets to the *resulting partnerships* in exchange for interests in the *resulting partnerships*. Then the *prior partnership* will be treated as liquidating and distributing the interests in the *resulting partnerships* to the prior partnership's partners. *Id.* § 1.708-1(d)(3)(i)(B).



Like the partnership merger rules, the partnership division regulations include an anti-abuse rule. The anti-abuse rule provides that, if the division is part of a larger series of transactions, the Service can disregard the form of the division "and recast the larger series of transactions in accordance with their substance."[40]

2. Application of the Assets-Up Construct

As in partnership mergers, the assets-up construct as applied to partnership divisions largely respects form; the assets-up construct will only apply if the assets are actually transferred up to the partners.[41] Such

40. *Id.* § 1.708-1(d)(6).
41. *Id.* § 1.708-1(d)(3)(ii).

transfers are subject to the same limitations and requirements as discussed in connection with the assets-up construct for partnership mergers.[42] Moreover, in order for the assets-up form to be respected, *all assets* that are ultimately transferred to the recipient partnership must be distributed by the divided partnership to, and then contributed to the recipient partnership by, the partners of the recipient partnership.[43]

3. *Application of the Assets-Over Construct*

As in partnership mergers, the assets-over construct applies not only to division transactions actually taken in the assets-over form, but also to all partnership divisions that do not qualify for assets-up treatment. This includes formless divisions,[44] divisions where only some of the assets of the recipient partnership are transferred through the assets-up form,[45] divisions where the prior partnership contributes certain assets into an LLC and then distributes the interests in the LLC to the prior partnership's partners,[46] and any other divisions that do not comply with the assets-up requirements.

As with partnership mergers, tax analysis of a division may follow its form, but often results in the application of legal fictions. For instance, the assets-over construct applies to a wide variety of transactions, many of which do not involve the transfer of assets at all. Likewise, continuing and divided partnerships may not even exist as state law entities prior to the division. Thus, the transfers that are deemed to occur in a division under the Final Section 708 Regulations[47] may be entirely fictional and markedly different from the actual transfers that occur.

---

42. *See supra* Part II.A.2.

43. Treas. Reg. § 1.708-1(d)(3)(ii)(A) (as amended in 2002). Similarly, if there is no divided partnership, the prior partnership must transfer *all of its assets* to the resulting partnerships and then liquidate; if the prior partnership does not liquidate under the applicable jurisdictional law, then the assets that are not transferred in this assets-up form will be treated as transferred in an assets-over transaction. *Id.* § 1.708-1(d)(3)(ii)(B).

44. *See, e.g.*, *id.* § 1.708-1(d)(5) (ex. 5).

45. *See, e.g.*, *id.* § 1.708-1(d)(5) (ex. 3).

46. This may appear close to an assets-up form given that the transfer of all of the interests in a single member LLC is generally viewed as transferring the underlying assets for federal income tax purposes, because an owner of a single member LLC is generally treated as owning the assets of the LLC for federal income tax purposes. Treas. Reg. § 301.77-1-3(b). However, the partners receiving the distribution do not actually become owners of the underlying assets under local law, since local law generally respects LLCs as real entities. Hence, the transfer does not qualify for assets-up treatment and the assets-over default rule applies.

47. *See supra* note 13.

C. *Partnership Incorporations*

1. *General Rules*

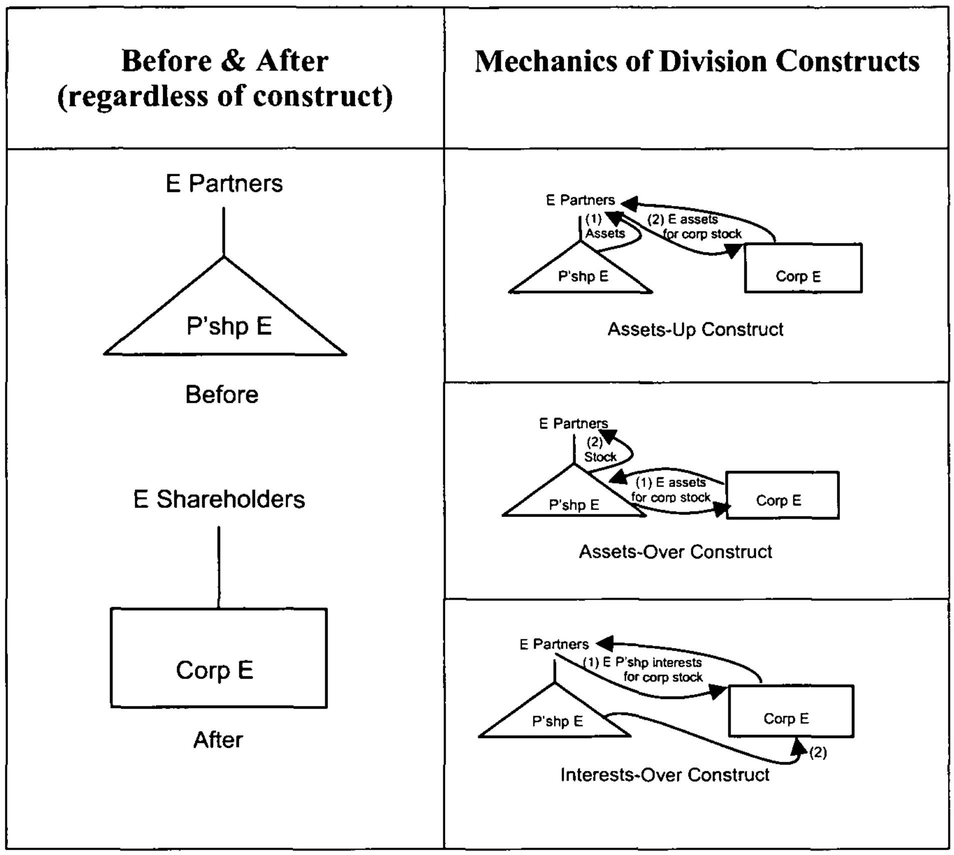
In contrast to the IRS's approach to partnership mergers and divisions, the IRS, in Revenue Ruling 84-111, ruled that it will respect each of three different forms for incorporating a partnership: assets-up, assets-over, and interests-over.[48] Under the assets-up construct, the partnership is treated as distributing all of its assets and liabilities up to its partners in liquidation, and then the partners are treated as contributing all of the distributed assets to a newly formed corporation in exchange for all of the stock of the corporation and the new corporation's assumption of all of the partnership's liabilities that had been assumed by the partners.[49] Under the assets-over construct, the partnership is treated as transferring all of its assets and liabilities over to a newly formed corporation in exchange for all of the stock in the corporation and then distributing the stock to the partnership's partners in liquidation.[50] Under the interests-over construct, the partners of the partnership are treated as transferring all of their partnership interests over to a newly formed corporation in exchange for all of the stock in the newly formed corporation, and the newly formed corporation is treated as receiving all of the assets and liabilities of the partnership.[51]

The Service recently addressed the treatment of "formless" incorporations (that is, a conversion of a partnership to a corporation under a state law statute that does not require an actual transfer of assets or interests), and the Service concluded that Revenue Ruling 84-111 does not apply to formless incorporations.[52] Instead, a partnership that undertakes a formless incorporation will be treated as if it had elected under the "check-the-box" regulations to be treated as an association taxable as a

48. Rev. Rul. 84-111, 1984-2 C.B. 88.
49. *Id.*
50. *Id.*
51. *Id.* Note that the interests-over construct produces asymmetrical treatment for the partners and the corporation. The partners are treated as transferring interests, but the corporation is treated as receiving assets. In the general counsel memorandum supporting Revenue Ruling 84-111, the IRS cited *McCauslen v. Comm'r*, 45 T.C. 588 (1966) and Rev. Rul. 67-65, 1967-1 C.B. 168, for the proposition that "although the partners are transferring their partnership interests, for purposes of determining tax consequences to [the new corporation, the new corporation] is viewed as receiving not interests in an ongoing partnership, but rather as receiving the partnership assets." Gen. Couns. Mem. 37,540 (May 18, 1978).
52. Rev. Rul. 2004-59, 2004-21 C.B. 1050.

corporation.[53] That is, the formless incorporation will be treated as an assets-over incorporation.[54]

Again, note that all of the forgoing approaches to incorporations lead to the same substantive result:



53. *Id.*; Treas. Reg. § 301.7701-2, -3 (as amended in 2006). The check-the-box regulations govern the tax classification of business entities. They provide default rules for the tax classification of business entities as disregarded entities, partnerships, and associations taxable as a corporations. With some exceptions for entities that are "per se" corporations, the regulations generally allow business entities to elect their tax classification by filing a form and checking a box, hence the check-the-box moniker. See *infra* Parts IV.A.2.c and IV.B for discussions of the check-the-box rules and how they coordinate and should coordinate with the rules regarding partnership mergers, divisions and incorporations.

54. When a partnership elects to be treated as a corporation for federal income tax purposes, the check-the-box regulations provide that the assets-over construct applies to the conversion. Treas. Reg. § 301.7701-3(g)(1)(i) (as amended in 2006).

2. Application of the Assets-Up, Assets-Over and Interests-Over Constructs

Under Revenue Ruling 84-111, the application of the different constructs generally adheres to the form of partnership incorporations. For instance, the assets-up construct appears to require the actual distribution of all of the partnership's assets and liabilities up to the partnership's partners, followed by an actual transfer of those assets to the new corporation in exchange for all of the stock in the corporation.[55] Note that the assets-up requirements in partnership incorporations are slightly different from mergers and divisions in that (a) Revenue Ruling 84-111 requires an actual distribution of assets but does not explicitly rely on local law like the partnership merger and division regulations do, and (b) Revenue Ruling 84-111 seems to require that the partners actually assume the partnership's liabilities in addition to receiving the partnership's assets, whereas the partnership merger and division regulations do not require liability assumption. Like the assets-up construct, application of the interests-over construct to partnership incorporation is also based on the actual form of the transaction. In contrast, the assets-over construct applies not only to incorporations actually undertaken in an assets-over form, but also applies, as a fiction, to formless incorporations.

D. Tax Consequences of the Different Constructs

The tax consequences to partners and entities in partnership mergers, divisions, and incorporations can vary widely based on whether an assets-up, assets-over, or, where applicable, interests-over construct is applied. The IRS, in promulgating the guidance regarding the tax treatment of these transactions, has explicitly acknowledged these differences.[56]

---

55. Rev. Rul. 84-111, 1984-2 C.B. 88; *see also* I.R.S. Priv. Ltr. Rul. 86-13-051 (Apr. 4, 1986) (applying the assets-up construct where the partnership liquidated and distributed its assets and liabilities to the partners). *But see* I.R.S. Priv. Ltr. Rul. 94-21-018 (Feb. 23, 1994) (applying the assets-up construct where the assets are "constructively distributed" and the partners "direct the transfer of assets" to the corporation).

56. Rev. Rul. 84-111, 1984-2 C.B. 88 states:

> The premise in Rev. Rul. 70-239 that the federal income tax consequences of the three situations described therein [assets-over, assets-up, and interests-over] would be the same, without regard to which of the three transactions was entered into, is incorrect. As described below, depending on the format chosen

Particularly since the promulgation of the Proposed Section 708 Regulations[57] regarding the various constructs for partnership mergers and divisions, considerable attention has been focused on the tax consequences of the different constructs, and other commentators have ably provided technical analyses of these disparate tax consequences in the context of mergers and divisions,[58] as well as incorporations.[59] Although this Article does not intend to retread this well-traveled path, it is useful to summarize the key potential differences between the constructs.

Depending on the form of merger or division, a resulting partnership's basis and holding period in its assets and a partner's basis and holding period in its interest in the resulting partnership can vary.[60] The form of a merger or division can also affect the likelihood and extent of gain

---

> for the transfer to a controlled corporation, the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners can vary.

Id. at 89; *see also* Partnership Mergers and Divisions, 65 Fed. Reg. 1572, 1573–75 (proposed Jan. 11, 2000) ("Like partnership incorporations, each form of a partnership merger has potentially different tax consequences. . . . As with partnership mergers, the IRS and Treasury recognize that different tax consequences can arise depending on the form of the partnership division.").

57. *See supra* note 13.

58. *See, e.g.*, MCKEE ET AL., *supra* note 16, at ¶ 12.06; 2 ARTHUR B. WILLIS ET AL., PARTNERSHIP TAXATION ¶ 16.03 (3d stud. ed. 2000); Eric B. Sloan et al., *Partnership Mergers and Divisions: A User's Guide*, *in* TAX PLANNING FOR DOMESTIC & FOREIGN PARTNERSHIPS, LLCS, JOINT VENTURES & OTHER STRATEGIC ALLIANCES 2006, at 421, 460–96 (PLI Tax Law & Estate Planning, Course Handbook Series No. 702, 2006), *available at* WL 702 PLI/Tax 421; Barbara Spudis de Marigny, *Mergers & Divisions of Partnerships*, *in* TAX PLANNING, *supra*, at 531, 540–44, 545–46, 552–58, *available at* WL 702 PLI/Tax 531; Barksdale Hortenstine et al., *Final Partnership Merger and Division Regulation—Analysis, Commentary and Examples*, *in* TAX PLANNING, *supra*, at 293, 309–14, 364–69, *available at* WL 702 PLI/Tax 293; Susan Kalinka, *Proposed Regulations Concerning Partnership Mergers and Divisions Provide Guidance and Some, But Not Enough, Flexibility*, 78 TAXES 15 (2000).

59. *See, e.g.*, MCKEE ET AL., *supra* note 16, at ¶ 17.03; WILLIS ET AL., *supra* note 58, at ¶ 12.05; Banoff, *supra* note 3; Cheryl Metrejean & Clair Y. Nash, *Tax Consequences of a Formless Conversion Following Rev. Rul. 2004-59*, 83 TAXES 43 (2005).

60. For example, in an assets-over merger, the terminated partnership's basis in the assets carries over to the resulting partnership pursuant to Section 723, whereas in an assets-up merger, the basis in the assets is stepped up or down to the partners' outside basis in their partnership interests pursuant to Section 732(b), and this stepped up or down basis carries over to the resulting partnership. Although this difference can be ameliorated if the resulting partnership makes an election under Section 754, not all partnerships will have a Section 754 election in effect, and even if such election is in effect, the allocation of the basis step-up may be different in the assets-over and assets-up scenarios. *See* de Marigny, *supra* note 58, at 539–43; *see also* Glen E. Goold & Steven R. Schneider, *Finding the Gold Nuggets in Partnership Holding Periods*, 81 TAXES 47 (2003) (discussing the effect of incorporations, partnership mergers and partnership divisions on holding periods); Eric B. Sloan et al., *Partnership Mergers and Divisions: A User's Guide*, *in* TAX PLANNING, *supra* note 58, at 461–64 (discussing the basis consequences of different partnership division constructs).

recognition, including gain recognition resulting from the shifting of liabilities,[61] and gain recognition with respect to appreciated properties pursuant to Section 704(c) and Section 737.[62]

Similarly, as noted by the IRS in Revenue Ruling 84-111, depending on the construct for incorporation, "the basis and holding periods of the various assets received by the corporation and the basis and holding periods of the stock received by the former partners can vary."[63] In addition, the form of incorporation can disparately affect other tax consequences as well, such as the occurrence and extent of gain recognition by the former partners upon incorporation (including pursuant to Sections 704(c) and 737),[64] the character of any such gain recognized,[65] the ability of the new corporation to elect to be taxed as an

61. If a partner's share of partnership liabilities is treated as decreasing in a merger or division, the partner is treated as receiving a deemed distribution under Section 752, which could result in gain recognition by the partner pursuant to Section 731. Prior to the Section 708 Regulations, the risk of gain recognition was particularly acute in the context of assets-over mergers because the terminated partnership could be treated as if it received a deemed distribution in the first step of the assets-over transaction, and the consequences of that gain recognition would flow through to the partners of the terminated partnership. In order to address this risk, the Section 708 Regulations incorporate a "netting" concept for purposes of determining whether a partner has a decrease in its share of partnership liabilities as a result of a merger. *See* Treas. Reg. § 1.752-1(f) (as amended in 2005); Partnership Mergers and Divisions, 65 Fed. Reg. 1572 (proposed Jan. 11, 2000). However, the language of this netting rule technically only applies to mergers, so the application of the netting concept in partnership divisions is less clear.

62. The application of Section 704(c) and Section 737 to partnership mergers and divisions has been the subject of much discussion. In the preambles to both the Proposed Section 708 Regulations and Final Section 708 Regulations, the Service flagged Section 704(c) and Section 737 as areas for study and future guidance. Partnership Mergers and Divisions, 65 Fed. Reg. 1572, 1576 (proposed Jan. 11, 2000); T.D. 8925, 2001-1 C.B. 496. Rev. Rul. 2004-43, 2004-1 C.B. 842 was intended to provide published guidance regarding the application of these provisions to an assets-over partnership merger, but it was revoked by Rev. Rul. 2005-10, 2005-7 I.R.B 492 under heavy criticism. The Service's 2006–2007 Priority Guidance Plan includes the promulgation of regulations under Sections 704(c) and 737 regarding partnership mergers. Eric Solomon et al., *Department of the Treasury First Periodic Update of the 2006-2007 Priority Guidance Plan* (Mar. 12, 2007), http://www.irs.gov/pub/irs-utl/2006-2007pgp.pdf.

63. Rev. Rul. 84-111, 1984-2 C.B. 88, 89; *see also* Goold & Schneider, *supra* note 60.

64. *See, e.g.*, WILLIS ET AL., *supra* note 58, at ¶ 12.05 (indicating that the gain recognition upon the transfer and the characterization of the gain can vary depending on the method of incorporation), ¶ 13.02[1][a][v] (discussing the application of Section 737 to incorporations).

65. *Id.* at ¶ 12.05.

S corporation,[66] and the availability of an ordinary loss deduction under Section 1244 if the stock of the corporation becomes worthless.[67]

None of the constructs is certain to produce the most tax favorable result for the taxpayer. Although the Service has indicated that it believes the assets-over construct will generally be preferable for taxpayers and the IRS,[68] the tax consequences of applying a particular construct to a transaction may be more or less favorable depending on the specific facts and circumstances of the taxpayer's situation.

III. INHABITING THE NO MAN'S LAND BETWEEN FORM AND FICTION

A. The Problems of Disparate Tax Treatment of Substantively Equivalent Transactions

As illustrated above, various forms can be used to accomplish the same economic transaction (turning two partnerships into one, one partnership into two, or a partnership into a corporation), but the tax consequences can vary depending on the construct used to analyze the transaction. Since a taxpayer may prefer the federal income tax results of one construct over the results of another, a taxpayer may try to structure a transaction in a particular form in order to achieve the preferred tax results.

However, the federal income tax consequence of a transaction is likely to be only one factor in the determination of what form to adopt for a given transaction. Numerous non-tax business factors are also likely to be relevant to the choice of form.[69] For example, a partnership's bank credit agreements or debt covenants may limit or preclude the partnership from actually transferring assets, and thus may militate in favor of an interests-over form or a formless structure for a transaction. Similarly, the assets-over and assets-up forms may be difficult to undertake if the partnership's contracts cannot be transferred without consent, if the actual transfer of assets would require complicated administrative filings, or if there are regulatory restrictions on the ability of the partnership to transfer assets, as there often are with permits and licenses. Formless

66. I.R.C. § 1361(b)(1)(B) (2005).

67. *See, e.g.*, WILLIS ET AL., *supra* note 58, at ¶ 12.05 (discussing various tax consequences of different methods of incorporation). *See generally* Rev. Rul. 84-111, 1984-2 C.B. 88 (mentioning several of these issues as potential adverse tax consequences to the assets-over construct).

68. *See, e.g.*, Partnership Mergers and Divisions, 65 Fed. Reg. 1572 (proposed Jan. 11, 2000).

69. Certain other tax issues not discussed herein, such as the transfer taxes under local law, may also be relevant.

transactions may be the simplest from the perspective of administrative and transaction costs.

On the other hand, limiting liability may be an overarching business concern. For example, if a resulting partnership in a merger wants to limit its exposure to undisclosed or contingent liabilities of the terminated partnership, the resulting partnership may prefer to receive the terminated partnership's business in an actual asset transfer (in either an assets-up or assets-over form), rather than in an interests-over transaction (in which the resulting partnership would actually end up owning the state law entity of the terminated partnership). The assets-up form may be particularly disadvantageous if there is a significant risk that the transferee will succeed to the liabilities associated with the asset (like environmental remediation responsibility, which can transfer to a subsequent owner along with the transfer of real estate);[70] individual partners are likely loathe to take on the exposure to such liabilities.

Moreover, partnership agreements often impose limitations on the ability of the partnership to undertake certain transactions, including liquidation, merger, division, incorporation, and the transfer of all or substantially all of the assets of the partnership.[71] These limitations may make it easier or harder for the partnership to undertake transactions in certain forms depending on the specific restrictions contained in the partnership agreement. For example, the assets-up and interests-over forms of transactions require the participation of all partners by their very form, whereas a partnership agreement may provide that a partnership can merge or transfer its assets with an affirmative vote from only a majority of the partners, but without unanimous consent. In that case, if there are dissenting partners, the partnership may be able to undertake a state law merger or an assets-over form of transaction but not an assets-up or interests-over form of transaction.

---

70. *See generally* William B. Johnson, Annotation, *Liability of Parent or Successor Corporation, or Corporate Shareholders in Action Pursuant to Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)*, 121 A.L.R. FED. 173 (1994) (discussing a successor entity's responsibilities for environmental liabilities of its predecessor, in the context of the acquisition of assets).

71. For example, the Uniform Limited Partnership Act (ULPA), Uniform Partnership Act (UPA), and the Uniform Limited Liability Company Act (ULLCA) each allow a merger to be approved by less than all of the partners if the operating agreement of the entity so provides. *See, e.g.*, UNIFORM LIMITED PARTNERSHIP ACT § 1110(a) (2001); UNIFORM PARTNERSHIP ACT § 905(c)(1) (1997); UNIFORM LIMITED LIABILITY COMPANY ACT § 904(c)(1) (1996).

If business factors support the use of a form that also produces the desired tax results for the partners and partnerships, then the choice of structure is easy. However, if the form of transaction that is most desirable from a business perspective results in unfavorable tax consequences to the partners and partnerships, the parties will likely weigh the costs and benefits of each form and employ the one that produces the best result on a net basis, taking both business and tax considerations into account. Thus, although they are not the sole consideration, the tax consequences of a transaction may influence the manner in which the transaction is undertaken. This is not an unusual result; it is well accepted that the imposition of tax affects taxpayer choices.[72] However, to the extent possible, such taxes should be imposed and such influence should be exerted in a manner consistent with various tax policy objectives such as neutrality, fairness and efficiency, among others.

As used herein, neutrality refers to the goal of minimizing the effect of the tax law on a taxpayer's choice of whether and how to undertake a transaction; that is, neutrality reflects the desire for tax law to be unbiased across taxpayer economic decisions.[73] The application of this neutrality principle in the situation where the transactions or decisions are substantively equivalent has been called "functional neutrality."

---

72. *See generally, e.g.*, 1 BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 3.2.1 (3d ed. 1999) ("Imposing a new tax or increasing an existing tax changes the prior relationship between the cost of engaging in the taxed activities and the rewards accruing to them."); Douglas A. Kahn, *Comments on "Tax Neutrality Between Equity Capital and Debt,"* 30 WAYNE L. REV. 1081, 1081 (1984) ("It is worth noting that the establishment of an income tax system necessarily introduces a bias that affects market behavior. That is not a happy consequence, but it is inevitable."); Stanley S. Surrey, *Tax Incentives as a Devise for Implementing Government Policy: A Comparison with Direct Government Expenditures*, 83 HARV. L. REV. 705 (1970). Even the government acknowledges the impact of taxes on taxpayer behavior. U.S. GOV'T ACCOUNTABILITY OFFICE, UNDERSTANDING THE TAX REFORM DEBATE: BACKGROUND, CRITERIA, & QUESTIONS 38 (2005), *available at* http://www.gao.gov/new.items/d051009sp.pdf ("Generally, taxes alter or distort decisions about how to use resources, creating economic inefficiencies.").

73. *See* Harold M. Groves, *Neutrality in Taxation*, 1 NAT'L TAX J. 18 (1948); David W. LaRue, *A Case for Neutrality in the Design and Implementation of the Merger and Acquisition Statutes: The Post-Acquisition Net Operating Loss Carryback Limitations*, 43 TAX. L. REV. 85 (1987); Kahn, *supra* note 72, at 1081; William D. Andrews, *Tax Neutrality Between Equity Capital and Debt*, 30 WAYNE L. REV. 1057 (1984) (discussing the elimination of bias); AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, UNDERSTANDING TAX REFORM: A GUIDE TO 21ST CENTURY ALTERNATIVES xi (2005), *available at* http://www.aicpa.org/download/tax/AICPA_Understanding_Tax_Reform.pdf (defining neutrality as the principle that "[t]he effect of the tax law on a taxpayer's decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum."); Inst. for Policy Innovation, *A Framework for Tax Reform*, 107 TAX NOTES 915, 917 (2005) ("An economically neutral tax is unbiased across economic activities.").

"Functional neutrality . . . calls for impartiality in the tax recognition and treatment of acquisitions which are functional equivalents of one another."[74] Accordingly, if the tax law was functionally neutral in its application to partnership mergers, divisions, and incorporations, tax law would not discriminate against any particular form of transaction or influence a taxpayer to take one form of transaction over another. However, as discussed above, taxpayers' decisions about what form of transaction to undertake are undoubtedly influenced by tax law because different forms of transactions lead to the application of different tax constructs and thus potentially different tax consequences. Moreover, because the impact of this bias depends partly on the non-tax business factors relevant to the choice of form, in practice, these tax rules discriminate more harshly against taxpayers who, for non-tax reasons, have greater difficulty in structuring their transactions to produce a desired tax result.

The concern about neutrality relates to similar concerns about fairness and efficiency. Fairness, or equity, suggests that "[s]imilarly situated taxpayers should be taxed similarly,"[75] but a party who undertakes one

---

74. LaRue, *supra* note 73, at 218; *see also id.* at 218 n.429 ("'[F]unctional neutrality' has little, if anything, to do with the formulation of policy, and everything to do with the design of rules intended to implement policy once formulated.").

75. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, *supra* note 73, at xi; *see also, e.g.*, Inst. for Policy Innovation, *supra* note 73, at 918 ("'Fairness' means equal treatment under the law, equal treatment for those equally situated, and no discrimination among taxpayers unequally situated unless that discrimination is consistent with the purposes and principles of a sound tax system."); LaRue, *supra* note 73, at 216 n.427 ("'Horizontal equity,' for example, requires that taxpayers of comparable economic circumstance bear correspondingly comparable tax burdens. The complementary, and generally accepted, notion of 'vertical equity' suggests not only that taxpayers of dissimilar economic circumstance bear dissimilar relative tax burdens, but also that this relationship be direct, rather than inverse."). LaRue also cites Professor Groves's article for purposes of distinguishing neutrality from equity:

> Professor Groves, perhaps one of the first commentators to explicitly isolate and define this concept, and to distinguish it from "equity," described neutrality in the following terms:
>
> > Neutrality . . . calls for impartiality of treatment. The partiality that we are concerned with may arise from: (1) unequal treatment of essentially similar taxpayers; or (2) the same treatment of essentially different taxpayers. Discrimination may be deliberate or inept. Its curse is removed when it is supported by adequate public purpose and ample prospect for achieving that purpose.
> >
> > The term "neutrality" as thus defined differs from "equity" . . . which include[s] an interest in economic equality as well as in impartiality. Thus taxes are said to be equitable when they make for a more even

form of partnership merger, division, or incorporation is likely to be taxed differently than a party who undertakes a different form of partnership merger, division, or incorporation, even though the different forms are substantively equivalent. Because of the lack of neutrality and equity, a rational taxpayer, after balancing the tax and non-tax factors influencing the choice of form, may choose a form that is more costly from a non-tax perspective solely to achieve more favorable tax results,[76] thereby diverting funds from more productive uses and introducing inefficiency.[77] If the various transaction forms were not taxed differently, such a rational taxpayer would have chosen the transaction form that allowed it to use its limited funds optimally, thereby accomplishing the transaction with fewer dollars, using the remaining dollars for more beneficial uses, and making all parties better off.

B. Other Considerations as Possible Explanations for Disparate Treatment

Admittedly, neutrality, fairness, and efficiency are not the only policy goals of taxation, and they are sometimes sacrificed in order to accomplish other policy objectives.[78] However, deviation from these basic goals should be supported by compelling justifications. This section discusses various alternate considerations that might explain the lack of neutrality, fairness, and efficiency in the tax rules regarding partnership mergers, divisions, and incorporations. This section concludes that not only do none of these considerations provide a satisfactory explanation

---

> distribution of economic reward. Neutrality has to do less with the standards applied to the over-all distribution of the tax load and more with the even application of those standards once they are chosen. There is no inference of conflict between the two canons. The thought is not that taxes should be neutral *rather than* equitable; they should be both. Or perhaps more accurately: taxes should be equitable and they should deviate from neutrality only for adequate public purpose.

Id. at 218 n.429 (citing Groves, *supra* note 73, at 18).

76. This assumes that the added tax benefits of the chosen form outweigh the additional non-tax costs of the chosen form. This is merely an example, and the reverse, where the rational taxpayer agrees to bear additional tax cost in order to achieve non-tax benefits, is equally plausible and problematic.

77. *See generally, e.g.*, AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, *supra* note 73; Inst. for Policy Innovation, *supra* note 73; Chris Edwards, *Options for Tax Reform*, 106 TAX NOTES 1529 (2005); U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 72 (each discussing efficiency as an important tax policy objective); A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS ch. 2 (2d ed. 1989) (discussing efficiency, among other economic principles, as applied to the legal system).

78. A very basic example of deviation from neutrality is the imposition of a tax on income from personal services, which influences taxpayers' choices between work and leisure. However, we accept that influence because of the need to raise revenue, among other reasons.

for the disparate treatment, but furthermore, analysis of some of the alternative considerations supports revising the tax rules applicable to partnership merger, division, and incorporation transactions.

1. Adherence to Form[79]

Despite the prevalence of the "substance over form" doctrine,[80] respect for form may still be a relevant consideration in the tax analysis of transactions, even though respecting form may lead to differing tax results for substantively equivalent transactions. This is particularly true where, as in the case of partnership mergers, divisions, and incorporations, looking to the substance of a transaction does not provide enough information about the tax consequences because the substance of the transaction can be accomplished through multiple, equally plausible, alternatives. In such a case, form can serve as a "tiebreak" rule. In addition, adhering to form can help ensure predictability of results, both by providing security for taxpayers that they are getting the deal they bargained for, and by preventing the government from getting whipsawed.[81]

However, adherence to form does not justify deviation from the principles of neutrality, fairness, and equity in the tax treatment of partnership mergers and divisions. In many partnership mergers and divisions, the form employed by the taxpayer is not respected at all; it is

---

79. Formless transactions, by definition, lack form to respect, so the "adherence to form" consideration cannot explain their tax analysis. Accordingly, formless transactions are excluded from this discussion. Nevertheless, for formless transactions, some construct must be adopted in order to analyze the tax consequences of the transaction. *See infra* Part IV (proposing such a construct).

80. *See, e.g.*, Estate of Weinert v. Comm'r, 294 F.2d 750, 755 (5th Cir. 1961) ("The principle of looking through form to substance . . . is the cornerstone of sound taxation . . . ."). *See generally* note 3 (collecting authorities).

81. *See* Steinberg, *supra* note 1, at 495–98 (discussing these and other explanations for the continued role of form in Subchapter C). Further, in some situations, the Service has asserted and the courts have ruled that the form chosen by taxpayers should be respected for purposes of determining the tax consequences of transactions, and that taxpayers should be obligated to accept the tax consequences of the form they have chosen. *See, e.g.*, Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967), *cert. denied*, 389 U.S. 858 (1967). This has been referred to as the "taxpayer non-disavowal principle," defined as "a fundamental notion that where the taxpayer, and not the government controls the facts, the taxpayer should be restricted in its ability to assert that the substance and not the form controls for tax purposes . . . ." Kenneth L. Harris, *Should There Be a "Form Consistency" Requirement?* Danielson *Revisited*, 78 TAXES 88, 89 (2000); *see also* William S. Blatt, *Lost on a One-Way Street: The Taxpayer's Ability to Disavow Form*, 70 OR. L. REV. 381 (1991).

totally ignored in favor of an assets-over fiction.[82] Further, even where form is purportedly followed for purposes of the tax analysis, as with an assets-up transaction, the purported application of form is often at least as much fiction as it is form. For example, when effectuating an assets-up form, the Service will respect a partnership's transfer to the partners of assets that the partners are precluded from owning under state law.[83] Hence, in order to respect this "formal" transfer, the Final Section 708 Regulations[84] suspend the state law reality. In addition, in respecting the assets-up form without requiring that liabilities be assumed by the partners, the Service is conceding the fiction created by Section 752. "Pursuant to Section 752 . . . a partner *essentially* is *deemed* to have directly incurred a share of the partnership's liabilities."[85] If the Service is willing to subscribe to that fiction for purposes of the "transfer" of liabilities, query why the Service is not also willing to respect the assets-up form without requiring that assets actually be transferred to the partners, on the basis of the "aggregate" theory of partnerships, whereby partners are viewed as owning a direct interest in each partnership asset.[86] In addition, the distribution of assets to the partners in an assets-up transaction would likely be disregarded under the step transaction

82. *See supra* Parts II.A.3, II.B.3.

83. For example, the preamble to the Final Section 708 Regulations and the regulations themselves indicate that the transfer of an asset to the partners will be respected even if the partners generally could not own the asset outside the partnership. *Id.*; Treas. Reg. § 1.708-1(c)(5) (ex. 3) (as amended in 2002). To illustrate this point, the Service cites goodwill (and specifically, the undivided interest in business goodwill that a partner might receive as part of an assets-up transaction) as the type of asset that might raise this problem. § 1.708-1(c)(5) (ex. 3); T.D. 8925, 2001-1 C.B. 496.

84. *See supra* note 13.

85. T.D. 8925, 2001-1 C.B. 496, 497 (emphasis added). To justify treating liabilities differently than assets for purposes of qualifying for treatment under the assets-up construct, the Service also explains that requiring partners to assume the partnership liabilities "could create a trap for the unwary" in that "[i]f a partner momentarily assumes an amount of the partnership's debt that is less than the partner's share of such debt under Section 752 . . . the partner could inappropriately recognize gain as a result of the deemed distribution." *Id.* at 497–98. However, the same could be said about distribution of assets. If a partner momentarily receives more than its share of the partnership assets, the partner could inappropriately recognize gain, just as if the partner assumed less than its share of partnership debt. Accordingly, it seems curious that the Service is concerned that partners are at greater risk for distributing liabilities incorrectly than they are for distributing assets incorrectly. Perhaps that is a tacit admission about the incredible complexity of the Section 752 regulations. I do not mean to advocate requiring that partners assume the partnership liabilities in order to qualify for assets-up treatment. Rather, I am suggesting that perhaps this explanation, justifying not requiring partners to actually assume partnership liabilities in order for the assets-up construct to apply, might also justify not requiring the partners to receive an actual local law transfer of the assets.

86. *See generally* MCKEE ET AL., *supra* note 16, at ¶ 1.02 (discussing aggregate and entity concepts in partnership taxation).

doctrine,[87] and the Service admits that the partnership's transfer of the assets up to the partners is transitory; however, the Final Section 708 Regulations affirmatively state that the formal transfers will be respected despite their transitory nature.[88] Admitting that the transfers are transitory acknowledges that they are empty forms, and respecting an empty form is tantamount to respecting a fiction.

In the context of partnership incorporations other than formless incorporations, the tax consequences are determined based on the actual form of the transactions. This reliance on form is justified, in part, by General Counsel Memorandum 37,540, which supports Revenue Ruling 84-111, and explains that the Service believed each of the forms of transactions should qualify as tax-free exchanges under Section 351.[89] In order to reach the conclusion that Section 351 applied in the assets-over form, the Service respected the interim step (the terminated partnership's contribution of assets in exchange for stock), even where the partnership had a prearranged plan to transfer the stock of the corporation that the partnership received in exchange for the contribution of assets.[90] The regard for form, which leads to disparate

87. An assets-up transaction is likely to occur pursuant to a set of prearranged steps, memorialized in one set of transaction documents that obligates the partners to contribute the assets immediately after receiving them in a distribution so that the distribution will not occur without the contribution. This would likely satisfy the step transaction doctrine, regardless of whether the "end result," "binding commitment," or "interdependence" version of the step transaction doctrine was used. Hence, the intermediary step of distributing the assets up to the partners would be disregarded in determining the tax consequences of the overall transaction. *See generally* BITTKER & LOKKEN, *supra* note 72, at ¶ 4.3.5; Stephen S. Bowen, *The End Result Test*, 72 TAXES 722, 722 (1994).

88. Treas. Reg. § 1.708-1(c)(3)(ii) (as amended in 2002) (respecting the assets-up form of merger "[d]espite the partners' transitory ownership of the terminated partnership's assets"); *id.* § 1.708-1(d)(3)(ii) (respecting the assets-up form of division "[d]espite the partners' transitory ownership of some of the prior partnership's assets").

89. Gen. Couns. Mem. 37,540 (May 18, 1978).

90. Under Section 351, if a transferor transfers property to a corporation in exchange for stock of the corporation and is in "control" of the corporation immediately after the transfer, no gain or loss is generally recognized. I.R.C. § 351 (2000). In order to meet the "control" test, the transferors must own at least 80% of the total voting power of all classes of the corporation's stock entitled to vote and at least 80% of the total number of shares of each class of non-voting stock. I.R.C. § 368(c) (2000). In applying this rule, the Service usually takes into account any preplanned transfers. *See generally* 2 MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS ¶ 608.3.4 (2006) (collecting authorities). Thus, allowing an assets-over incorporation to be treated as a non-recognition event under Section 351 is an exception to the general rule because the partnership has a prearranged plan to transfer the corporate stock immediately

tax treatment of substantively equivalent transactions, could also be explained as a tiebreaker; "when the form and substance of a transaction are consistent, that form should be respected even though it was chosen in order to enhance tax efficiency and even though other (presumably less tax-efficient) forms could have been utilized to achieve the same (non-tax) economic results."[91]

Notwithstanding these plausible explanations for regarding form in incorporation transactions, the end result of disparate tax consequences from incorporation structures, which result in substantively equivalent transactions despite their technical distinctions, remains unsatisfying for a number of reasons.[92] First, there are possible alternate approaches for dealing with the Section 351 issue in the assets-over form.[93] Also, this result conflicts with the overarching policy concerns of neutrality, fairness, and efficiency discussed in Part III.A. Lastly, for non-tax reasons, some taxpayers have difficulty or are entirely unable to structure their transaction to obtain the desired tax results, as also discussed in Part III.A. This Article's proposal, as outlined in Part IV, would protect Section 351 treatment, allow for the use of all three incorporation constructs, and minimize neutrality, fairness, and efficiency concerns.

2. *Simplicity and Administrability*

Simplicity and administrability also do not explain the deviations from the goals of neutrality, fairness, and efficiency identified in Part III.A.[94]

---

receiving the stock in exchange for a contribution of assets to the corporation. Meeting the control test of Section 351 is not a problem under the assets-up or interests-over forms of incorporation because in each of those cases the partners make the direct contribution to the corporation in exchange for the corporation's stock.

91. Steinberg, *supra* note 1, at 498.

92. *But see* Banoff, *supra* note 3 (generally endorsing an approach that adheres to form).

93. For example, the Service could take the approach that it took in Rev. Rul. 2003-51, 2003-1 C.B. 938, which concluded that the Section 351 control test was not violated by prearranged multiple drop-downs of the stock received in the first exchange as long as there was an "alternative form of transaction that would have qualified for nonrecognition treatment." Rev. Rul. 2003-51, 2003-1 C.B. 938, 940. Specifically, the Service could rule that the Section 351 control test is not violated by the partnership's prearranged liquidating distribution of the corporate stock to the partners because there are other forms of transactions, specifically the assets-up and interests-over forms, that would have qualified under Section 351.

94. As used herein, "simplification," which is an oft-discussed goal of tax reform, generally refers to the goal of a tax system that minimizes complexity to the extent possible. *See generally* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, *supra* note 73; Inst. for Policy Innovation, *supra* note 73; William G. Gale & Jeffrey Rohaly, *Effects of Tax Simplification Options: A Quantitative Analysis*, *in* THE CRISIS IN TAX ADMINISTRATION 276, 276 (Henry J. Aaron & Joel Slemrod eds., 2004); AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, GUIDING PRINCIPLES FOR TAX SIMPLIFICATION (2002), *available at*

Despite the Service's intent to create an appropriately simple and administrable system,[95] the rules regarding the tax analysis of partnership mergers, divisions, and incorporations are simultaneously too simple and not simple enough.

The partnership merger, division, and incorporation rules are too simple in three respects. First, the rules allow the use of only the assets-over fiction for formless mergers, divisions, and incorporations. Query why only one fiction is permitted to apply to a transaction when other, equally plausible, fictions could be used to explain and analyze the same transaction. Second, the merger rules do not allow the interests-over construct. The Service allowed only the assets-over and assets-up constructs for mergers in an effort "to provide a set of administrable rules that taxpayers and the IRS could apply in characterizing these transactions."[96] In specifically choosing not to allow an interests-over construct, the Service cites "problems . . . that are not present with respect to partnership incorporations."[97] "The operation of [Section 704(c) and 737] breaks down if the partner is treated as contributing an asset that is different from the asset that the partnership is treated as receiving."[98] However, given that the interests-over merger construct, if allowed, might have the best tax results for the taxpayer,[99] and given that the

http://www.aicpa.org/download/members/div/tax/Tax_Policy_stmt2.pdf; N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON SIMPLIFICATION OF THE INTERNAL REVENUE CODE (2002), *available at* http://www.nysba.org/Content/ContentGroups/Section_Information1/Tax_Section_Reports/1007report.pdf; Edwards, *supra* note 77, at 130–32 (discussing problems that flow from complexity). *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 72, at 45–47. As used herein, "administrability" generally refers to the ability of the Service to administer the tax system, including cost-effective collection and enforcement. *See generally* AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, *supra* note 73; U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 72, at 49–52.

95. Before Revenue Ruling 84-111 and the Section 708 Regulations, partnership incorporations and mergers were analyzed using only an assets-over construct. *See supra* notes 13–14. Although this single construct approach was simple and easy to administer, by publishing Revenue Ruling 84-111 and promulgating the Section 708 Regulations the IRS accepted multiple constructs and implicitly acknowledged that the single construct approach oversimplified the analysis by trying to "provide a set of administrable rules." T.D. 8925, 2001-1 C.B. 496.

96. T.D. 8925, 2001-1 C.B. 496.

97. Partnership Mergers and Acquisitions, 65 Fed. Reg. 1572, 1573 (proposed Jan. 11, 2000).

98. *Id.*

99. *See* Kalinka, *supra* note 58.

Section 704(c) and Section 737 concerns are surmountable,[100] the marginal increase in complexity associated with allowing a third construct for partnership mergers seems justifiable. Third, the merger rules only allow partial interests sales pursuant to the buyout rule in the assets-over construct and not the assets-up construct.[101] The buyout rule could be easily expanded to provide explicitly for interest sales prior to any asset construct merger, thus ensuring that a partner wishing to sell out can avail itself of the tax treatment provided in Section 741 regardless of how the transaction is structured. The provision could be based on, and could operate in precisely the same way as, the assets-over version of the buyout rule.[102]

In addition to oversimplifying, the rules regarding the use of the assets-up construct introduce unnecessary complexity by imposing nuanced requirements on the ability to obtain assets-up treatment.[103] Less sophisticated taxpayers are disadvantaged because they may not fully understand how to avail themselves of the assets-up construct, and thus are more likely, albeit inadvertently, to become subject to the default assets-over fiction. Additionally, the particularities of the assets-up requirements increase the costs of administering and monitoring compliance with the partnership transaction rules because they require the Service to delve into the individual local law of transfers in order to see whether a purported assets-up transaction really qualifies for analysis under the assets-up construct.

Since the partnership merger, division, and incorporation rules do not strike the right balance of simplicity and administrability, these considerations cannot justify the disparate tax consequences of the different forms of partnership transactions. In fact, rectifying each of the outlined oversimplifications and overcomplications would actually advance the goals of neutrality, fairness, and equity, and can be accomplished without substantially increasing the burden of administering these rules.[104]

---

100. *See id.* at 26–27 (discussing how §§ 704(c) and 737 could apply to an interests-over merger).

101. The articulated policy rationale for the buyout rule is that:

> The IRS and Treasury believe that, under certain circumstances, when partnerships merge and one partner does not become a partner in the resulting partnership, the receipt of cash or property by that partner should be treated as a sale of that partner's interest in the terminating partnership to the resulting partnership, not a disguised sale of the terminating partnership's assets.

Partnership Mergers and Acquisitions, 65 Fed. Reg. at 1574. This rationale seems to apply equally to any merger construct.

102. Treas. Reg. § 1.708-1(c)(4) (as amended in 2002).

103. *See supra* Parts II.A.2, II.B.2, II.C.2.

104. *See infra* Part IV (suggesting such a proposal).

3. *A Broader Approach to Equity Considerations—Consistency with Related Tax Provisions*

Part III.A was concerned with equity in the tax treatment of the various forms of substantively equivalent partnership mergers, divisions, and incorporations. However, the rules on these transactions are part of a larger scheme of rules that addresses the tax consequences of transfers of partnership interests and changes in form—that is, among entities characterized as corporations, partnerships, and disregarded entities. Equity considerations within this larger context are an important part of providing a cohesive framework for treating similar partnership transactions similarly and different partnership transactions differently,[105] and are useful in analyzing whether the disparate treatment of the various forms of partnership mergers, divisions, and incorporations can be justified. The key sets of rules with which the partnership merger, division, and incorporation rules should be coordinated are the check-the-box regulations regarding elective changes to an entity's tax classification, and the authorities regarding transfers of partnership interests, including the Section 708 "technical termination" regulations and Revenue Ruling 99-6.[106] These sets of rules are discussed in turn.

---

105. *See supra* note 75 and accompanying text (discussing and defining equity considerations).

106. One could assert that many other sets of rules ought to be included in this list, such as the rulings regarding conversions between different partnership forms (for example, Rev. Rul. 84-25, 1984-1 C.B. 157) or even the rules regarding transfers of interests and assets under Subchapter C (that is, Sections 301 to 385 of the Code). The rulings regarding conversions between different partnership forms are omitted from this discussion because they essentially conclude, without much discussion of the construct for the conversion, that the conversion is not a recognition event, except to the extent that the partners have different shares of the entity's liability after the conversion. *See* Rev. Rul. 84-52, 1984-1 C.B. 157; Rev. Rul. 95-37, 1995-1 C.B. 130. However, it is interesting to note that although these conversions could potentially be effectuated through a number of different forms for state law purposes, these rulings seem to adopt an interests-over construct for the conversion, so that partners are treated as exchanging their old partnership interests for new partnership interests in a transaction governed by Section 721 of the Code. *See* CARTER G. BISHOP & DANIEL S. KLEINBERGER, LIMITED LIABILITY COMPANIES ¶ 12.04[1] (2006). *See generally* Sheldon I. Banoff, *Partnership Ownership Realignments via Partnership Reallocations, Legal Status Changes, Recapitalizations and Conversions: What Are the Tax Consequences?*, 83 TAXES 105 (2005) (discussing the realization, recognition, and resulting tax consequences arising from conversions, among other partnership ownership changes). The Subchapter C restructuring rules are omitted from this list because of the vast differences between the Subchapter C and Subchapter K regimes for taxing business entities. Nonetheless, a number of the criticisms levied in this Article against the Subchapter K merger, division,

a. Check-the-Box Regulations[107]

The check-the-box regulations provide that a partnership that makes an entity classification election to be taxable as a corporation is deemed to undertake an assets-over incorporation for federal income tax purposes.[108] The Service adopted this assets-over fiction in Revenue Ruling 2004-59, concluding that the tax consequences of incorporations effectuated under state law formless conversion statutes are also determined based on an assets-over fiction.[109] Although formless state law incorporations and check-the-box conversions are afforded equivalent treatment for federal income tax purposes, these methods of incorporation are treated differently than other methods of incorporation, which under Revenue Ruling 84-111 can be analyzed under three alternative constructs.[110] In order to justify allowing only one construct rather than three, which is a departure from Revenue Ruling 84-111, the preamble to the check-the-box regulations cites Revenue Ruling 84-111's adherence to form,[111] as well as the Service's desire to "achieve administrative simplicity."[112] Further, in order to justify the choice of the assets-over construct as the single fiction to impose, the preamble to the proposed check-the-box regulations indicates a desire to "minimize the tax consequences of the change in classification," but does not conclude that the assets-over construct necessarily produces the best tax result for taxpayers in all circumstances.[113] These statements provide only a weak justification, at best, for the differential tax treatment of check-the-box conversions and state law formless incorporations on one hand, and state

---

and incorporation rules could also be levied against the reorganization rules in Subchapter C. I leave the comparison of the Subchapter K and Subchapter C restructuring rules to another day. See generally Steinberg, *supra* note 1, for a useful discussion about the role of substance and form in Subchapter C, including in the context of reorganizations.

107. Treas. Reg. § 301.7701-3 (as amended in 2006); *see also supra* notes 53–54 and accompanying text (discussing the check-the-box rules).

108. Treas. Reg. § 301.7701-3(g)(1)(i) (as amended in 2006).

109. Rev. Rul. 2004-59, 2004-21 C.B. 1050.

110. *See supra* Part II.C. (discussing Rev. Rul. 84-111, 1984-2 C.B. 88).

111. Treatment of Changes in Elective Entity Classification, 62 Fed. Reg. 55,768 (proposed Oct. 28, 1997) ("The proposed regulations do not affect the holdings in Rev. Rul. 84-111 (1984-2 C.B. 88), in which the IRS ruled that it would respect the particular form undertaken by the taxpayers when a partnership converts to a corporation.").

> Because elective conversions are transactions without actual form, the IRS and Treasury believe that it is appropriate to provide that only one transaction form will be applied to each type of elective conversion. Furthermore, while the check-the-box regulations provide an elective regime for classifying eligible entities, the elective regime was not intended to substitute for actual transactions in all situations.

T.D. 8844, 1999-2 C.B. 661, 662.

112. Treatment of Changes in Elective Entity Classification, 62 Fed. Reg. at 55,769.

113. *Id.*

law incorporations effectuated through an actual form on the other hand. Further, as discussed below in Part IV.A.2.c, the Service's more general rationale for the adoption of the check-the-box regulations seems to lend greater support to allowing more taxpayer choice in the tax treatment of incorporations, which could more closely align the tax treatment of check-the-box conversions, state law formless conversions, and state law formal conversions.

Even if no change is made to the tax treatment of check-the-box conversions, state law formless conversions could be treated in a manner more similar to the constructs in Revenue Ruling 84-111 without violating principles of equity. Revenue Ruling 2004-59's reliance on the check-the-box regulations reflects the Service's implicit assumption that a formless state law incorporation is more analogous to a partnership's check-the-box election to be taxable as a corporation than it is to a partnership incorporation effectuated through one of the forms described in Revenue Ruling 84-111.[114] This analogy seems inappropriate given that a check-the-box incorporation is only a change of federal income tax status and does not change the identity of the entity or affect the application of the state law business statutes. In contrast, a state law incorporation, whether undertaken in a formless manner or in one of the prescribed forms, is not merely a tax change; it is an actual change to the entity and the entity's state law rights and responsibilities. Accordingly, the better way to balance the equities is to conclude that *deemed* changes in tax classification are sufficiently different from changes in tax classification that result from *actual* changes to the parties' rights and responsibilities under state law. Under this approach, it is reasonable for check-the-box conversions to be treated differently from state law formless incorporations; because formless incorporations result in an *actual* change to the taxpayer, their tax treatment incorporations should be based on the three constructs from Revenue Ruling 84-111.

114. Rev. Rul. 2004-59, 2004-21 C.B. 1050.

b. Transfers of Partnership Interests

The preamble to the Proposed Section 708 Regulations cites the rules regarding technical terminations under Section 708(b)(1)(B) as precedent for "formless movements of a partnership's assets" in support for imposing the assets-over fiction on formless mergers and divisions.[115] Section 708(b)(1)(B) provides that a partnership will be treated as "terminated" if "within a 12-month period there is a sale or exchange of 50 percent or more of the total interest in partnership capital and profits."[116] Treasury Regulation § 1.708-1(b)(4) provides that, upon such "technical termination," the partnership is treated as undertaking an assets-over transaction.[117] However., using the technical termination rules as precedent for applying an assets-over fiction to formless transfers is unfounded because a technical termination is far from formless. Rather, a technical termination occurs upon a formal transfer of interests, and it is the regulations that recast this actual transfer of interests into a fictional transfer of assets. Because technical terminations are sufficiently distinguishable from formless mergers, the technical termination rules ought to have little probative value in determining the fiction that should be applied to formless transactions.

Although technical terminations are not analogous to formless transactions, the technical termination rules and Revenue Ruling 99-6, both of which involve tax constructs applied when partnership interests are transferred, may be relevant for determining, from an equitable perspective, how partnership mergers effectuated through the transfer of interests should be treated for tax purposes. As discussed above, the technical termination rules provide that if 50% or more of the interests in a partnership are sold or exchanged within a twelve-month period, the

115. Partnership Mergers and Divisions, 65 Fed. Reg. 1572, 1574 (proposed Jan. 11, 2000). The Service also cited the check-the-box regulations in selecting an approach to the tax treatment of formless partnership mergers and divisions. However, as with formless incorporations, formless mergers are even less similar to check-the-box conversions than are formless incorporations, such that formless mergers and divisions need not be treated in a manner similar to check-the-box conversions. *See supra* Part III.B.3.a.

116. I.R.C. § 708(b)(1)(B) (2000). This is commonly referred to as a "technical termination." The termination is "technical" in that the partnership may be treated as terminating for tax purposes, even though it continues to exist for state law purposes and continues to operate the same business, albeit with some different owners.

117. Treas. Reg. § 1.708-1(b)(4) (as amended in 2002) (treating the partnership as contributing all of its assets to a new partnership in exchange for interests in the new partnership, and then distributing the interests in the new partnership to the partners in liquidation). Note that prior to T.D. 8717, 1997-1 C.B. 125, interest transfers that resulted in technical terminations were treated as if the partnership undertook an assets-up transaction.

partnership is treated as undertaking an assets-over transaction.[118] The current regulations regarding the tax treatment of partnership mergers effectuated in an interests-over form are consistent with this assets-over treatment.[119] On the other hand, Revenue Ruling 99-6 provides that the purchase by one person of all of the interests in a partnership is treated as an interests-over transaction, as in Revenue Ruling 84-111 and *McCauslen v. Commissioner*.[120] The Final Section 708 Regulations are not consistent with Revenue Ruling 99-6; if all of the interests in a partnership were acquired by another partnership in a merger, Revenue Ruling 99-6 would seem to support allowing an interests-over construct, but the Final Section 708 Regulations would recast the transaction using an assets-over fiction. Although the Proposed Section 708 Regulations and Final Section 708 Regulations were promulgated after Revenue Ruling 99-6 was published, neither addresses this inconsistency.[121] Juxtaposing the technical termination rules and Revenue Ruling 99-6 produces an odd result, assuming both are respected—if the partners transfer 50% or more, but not all, of the interests in a partnership to one person, the assets-over construct applies, but if the partners transfer 100% of the interests in the partnership to one person, the interests-over construct applies. In the face of this incongruity, it seems just as reasonable, from an equitable perspective, to analyze a partnership merger structured in an interests-over form under an interests-over construct as it does to treat

118. I.R.C. § 708(b)(1)(B) (2000); Treas. Reg. § 1.708-1(b)(4) (as amended in 2002).

119. *See supra* Part II.A.3 (discussing the application of the assets-over fiction to mergers taken in an interests-over form).

120. Rev. Rul. 99-6, 1999-1 C.B. 432; McCauslen v. Comm'r, 45 T.C. 588 (1966).

121. One commentator, attempting (unsuccessfully) to rationalize Revenue Ruling 99-6 with the disregard for the interests-over construct in partnership mergers, explains as follows:

> Thus, it seems that the IRS and Treasury have implicitly limited Rev. Rul. 99-6 to nonpartnership acquirors or, perhaps, to nonpartnership acquirors and to partnership acquirors in fully taxable transactions. This would be consistent with the views of one IRS official, who has indicated that, although he had not previously considered this potential conflict between Rev. Rul. 99-6 and the Proposed Regulations, he finds significant the fact that the partners in Rev. Rul. 99-6 "sell" their interests for cash. Because a merger transaction, according to this official, involves an "exchange" rather than a sale, the Ruling would not apply. This view, however, does not seem to be consistent with [Gen. Couns. Mem. 37,540 (May 18, 1978)], underlying Rev. Rul. 84-111[, 1984-2 C.B. 88] . . . suggesting that McCauslen applies to partnership incorporations, which also are exchanges rather than sale transactions.

Eric B. Sloan et al., *New Prop. Regs. Provide Expanded Guidance on Partnership Mergers and Divisions—Part 1*, 93 J. TAX'N. 198, 206 n.40 (2000).

the transaction under an assets-over construct. Hence, looking to the tax treatment in similar transactions seems to provide little guidance regarding the proper treatment of partnership mergers that are structured as interests-over forms.

4. *Revenue Generation*

Which construct results in more revenue will depend on the particular facts and circumstances surrounding a transaction.[122] Just as there are situations in which an assets-over, assets-up, or interests-over construct is preferred by the taxpayer over the other constructs,[123] there are scenarios where each of the constructs as applied to incorporations, mergers, and divisions could produce more or less revenue than the other constructs. In fact, it is precisely the proposition that one construct may be less costly from a tax perspective than another form that presents the questions of neutrality and fairness in the first place. Thus, the need for revenue generation does not explain the disparate treatment of the different forms of transactions.

5. *Non-Tax Policy—Protection of Partners*

Tax rules can also be used to accomplish non-tax goals.[124] Although the Service's statements about the partnership merger, division, and incorporation rules do not indicate an intent to use these rules to accomplish non-tax goals, it is possible that non-tax goals, such as the protection of partners, could have informed or might help explain the imposition of an assets-over default rule and the differential treatment of the various tax forms. For example, if a formless transaction could be effectuated without unanimous consent of the partners, then treating that transaction, for tax purposes, under a construct that produced the *most* taxpayer-favorable tax result would help protect partners from adverse tax consequences in case transactions are undertaken without their consent. Alternatively, treating such a transaction under a construct that produced the *least* taxpayer-favorable tax result could incentivize the parties to obtain unanimous consent in order to opt out of the adverse tax treatment, thereby protecting partners by making it more likely that any transaction taken will be taken with the consent of each partner.

---

122. Revenue generation is a sine qua non of the federal income tax system.

123. *See supra* Part II.D.

124. For example, the Code contains numerous tax incentives that are designed to encourage or discourage certain behavior deemed beneficial or detrimental, respectively, from a non-tax social policy perspective. *See generally* Surrey, *supra* note 72 (discussing the use of the tax rules to implement government policy).

Setting aside the debate about which type of incentive would be more desirable, an incentive system of this sort could only be effective if it was clear what voting rights would be afforded to partners in each different form of transaction, and if it was clear which construct predictably produced the most and least taxpayer-favorable tax results. However, as discussed above, neither is clear.[125] Accordingly, the differential tax treatment of the various tax transaction constructs does not seem to be explainable by a desire to protect partners. Moreover, the disparate treatment *should not* be explained by a partner protection goal; if it is determined that partners need more protection than they are already afforded, that protection should be implemented either through the applicable state law statutes governing partnerships or on a case-by-case basis through the individual partnership agreements.

C. Objecting to Disparate Treatment

Based on the foregoing, it is submitted that failure of the rules governing the tax treatment of partnership mergers, divisions, and incorporations to meet the goals of neutrality, fairness, and efficiency is not justified by any of the above discussed policy considerations. Moreover, analyzing the partnership merger, division, and incorporation rules in light of these goals only strengthens the assertion that the existing rules do not strike the right balance with regard to the use of substance, form, and fiction. Accordingly, these rules are ripe for reform.

---

125. As to the ability to predict which constructs produce the most and least favorable tax results for the taxpayer, the benefits and detriments of a tax construct depend on the particular facts and circumstances of the situation. *See supra* Part II.D. As to partner voting rights under each construct, state law often allows partners to designate in a partnership agreement what portion of the partners must approve a transaction, so it would be unreasonable for the federal tax law to make assumptions about what voting rights were afforded to partners in different transactions. *See supra* note 71. Moreover, since there are already statutory regimes intended to set out the rights and responsibilities of partners and partnerships, such as the ULPA, UPA and ULLCA, and since partners can often establish their rights through contract, query why the *tax law* should be used to protect those who already have a statutory regime designed to address their issues and those who (at least those with sufficient leverage) already have the opportunity to protect themselves.

IV. PICKING A SIDE: A PROPOSAL TO ALLOW TAXPAYERS TO ELECT A FICTION

A. *Choosing Fiction*

1. *The Partnership Restructuring Election—A Proposal*

In order to address the issues raised in Part III, partnerships should be allowed to make an explicit election of which construct applies to their merger, division, or incorporation, regardless of the actual form of the transaction.[126] The election, which is referred to in this Article as the "Partnership Restructuring Election," would work as follows.

Taxpayers would implement the form of merger, division, or incorporation most preferable from a business perspective. Regardless of the form of transaction chosen, the entities involved in the transaction could elect which construct would apply to the transaction for federal income tax purposes.[127] For incorporations and mergers, the parties would choose among the assets-over, assets-up, and interests-over constructs; for divisions, they would choose between the assets-over and assets-up constructs.[128] If no election were made, the assets-over construct would apply as a default. The merger buyout rule would be made available in conjunction with any merger construct.

In order to make the election of construct, the entities involved in the transaction would jointly file a form of transaction election with the IRS no later than the due date for the terminated partnership's return for the year of the transaction, including extensions.[129] The Partnership

---

126. In the context of formless incorporations, others have similarly suggested allowing partnerships to elect the tax construct applicable.

> Why is the latitude available to taxpayers on actual conversions not extended to actual conversions involving "formless" incorporations as well as elective conversions? . . .
>
> . . . Parties should decide their preferred tax treatment, they should agree to report the transactions consistently both for themselves and the partnership, and the IRS should accord their choice controlling governance.

Philip F. Postlewaite, *The Transmogrification of Subchapter K*, 83 TAXES 189, 201 (2005). *But see* Banoff, *supra* note 3 (generally endorsing an approach that adheres to form).

127. Note that there are a number of potential structures pursuant to which a merger, division, or incorporation can be effectuated, but in an effort to ensure that this proposal is sufficiently simple and administrable, this proposal suggests that taxpayers only have a choice of three constructs. That said, taxpayers are still free to effectuate transactions in any manner that they see fit, as it is only for purposes of the tax analysis that they are limited to these three choices.

128. Recall that for divisions, there is no interests-over construct. *See supra* Part II.B.

129. This is consistent with the due dates for Section 754 elections (elections made with respect to the tax consequences of sales or exchanges of interests in partnerships). *See, e.g.*, Treas. Reg. § 1.754-1(b) (as amended in 2000).

Restructuring Election would be required to be filed jointly by the relevant entities,[130] which in an incorporation are the pre-incorporation partnership and the post-incorporation corporation, in a merger are the terminated partnership and the resulting partnership, and in a division are the divided partnership (or if none, the prior partnership) and the recipient partnership (or if none, the resulting partnerships). Like many other partnership tax elections,[131] this election would be made at the partnership, and not the partner, level; however, partners are, of course, free to incorporate into the partnership agreement limitations on the partnership's ability to make certain tax elections without partner consent. The partnerships would be bound to report the transaction in a manner consistent with the election, including on the Schedule K-1s that the partnership issues to the partners. Accordingly, as long as the partners report their income in a manner consistent with the K-1s that they receive, the partners would effectively be bound by the election as well.

The current anti-abuse rule for mergers and divisions would remain in place and would be expanded to cover incorporations. This would give the IRS the ability to recast a transaction in accordance with its substance if the transaction is part of a larger series of transactions and the substance of the larger series of transactions is inconsistent with following the fiction elected.

2. *Analogizing to Other Explicit Tax Elections*

The tax code is littered with tax elections, some explicit, whereby a taxpayer files a statement with the Service selecting a specific alternative,[132] and some implicit, whereby a taxpayer takes a certain action among various possible actions, thereby producing a particular tax result.[133]

130. This requirement is analogous to the requirement imposed in connection with the making of a Section 338(h)(10) election. *See* Treas. Reg. § 1.338(h)(10)-1(c)(3) (as amended in 2006). In addition, requiring a joint filing obligates the relevant entities to agree to treat the transaction consistently, thereby avoiding the risk of government whipsaw.

131. *See, e.g.*, Treas. Reg. § 1.754-1 (as amended in 2000) (stating Section 754 elections are made by the partnership); AICPA Tax Division's P'ship Taxation Technical Res. Panel, *Partnership Elections Grid*, 36 TAX ADVISER 200 (2005) (detailing a number of partnership elections).

132. *See infra* Parts IV.A.2.a–c (discussing three such examples).

133. Tax shelters are the most obvious example of taxpayers choosing among different actions that produce different tax results, but implicit elections need not be abusive. For example, an entity that chooses to raise capital as debt rather than equity is making a choice between having the tax consequences associated with debt (for

Treasury Regulation § 1.708-1 and Revenue Ruling 84-111 already set up a system for an implicit election between certain transaction fictions; by taking certain actions rather than others, a taxpayer can implicitly elect between an assets-over and assets-up construct for mergers and divisions, and among assets-over, assets-up, and interests-over constructs for incorporations.[134] This Article's proposed Partnership Restructuring Election would make this election explicit, and would remove the barriers that impede access to the implicit election by eliminating the *tax* impact of the non-tax factors that drive taxpayers to undertake a particular form of transaction over another.[135]

There is already precedent in the tax law for explicit elections of this type, where a taxpayer has the opportunity to choose to apply a tax fiction to a transaction in order to override the tax consequences of an actual form, or in the absence of certainty about the tax consequences of an actual form. For example, the Partnership Restructuring Election can be analogized to elections under Section 338, elections under Section 754, and check-the-box elections.

a. Section 338 Election—Treating Stock Purchases Like Asset Purchases

Elections under Section 338 of the Code allow taxpayers who purchase at least 80% of a corporation's stock, by total vote and value, to elect whether to determine the tax consequences of the acquisition on the basis of a fiction rather than the stock purchase form.[136] The precise fictions differ depending on which version of Section 338 election is made, but both versions enable taxpayers to choose to impose an asset

---

example, corporate level interest deduction, and holders pay tax at ordinary income rates on the interest) rather than having the tax consequences associated with equity (for example, no deduction for dividends paid, but individual holders may be able to pay tax at reduced rates, and corporate holders may benefit from the dividends-received deduction).

134. *See supra* Part II (discussing different actions that lead to the application of different constructs). The Service has acknowledged the implicit nature of this election. Revenue Ruling 84-111 explains that "[r]ecognition of the three possible methods to incorporate a partnership . . . will facilitate flexibility . . . ." Rev. Rul. 84-111, 1984-2 C.B. 88, 89. However, in promulgating the Final Section 708 Regulations, the Service acknowledged, but wanted to limit, the elective nature of the partnership merger and division rules. T.D. 8925, 2001-1 C.B. 496, 497 ("[T]he IRS and Treasury did not intend to establish a regime whereby partners essentially could elect between the Assets-Up Form and the Assets-Over Form by creating different documents that have the same legal effect.").

135. *See supra* Part III.A.

136. I.R.C. § 338(d)(3) (2000).

purchase fiction on a stock purchase form of transaction.[137] The purposes of the enactment of Section 338 included simplification, the desire to mitigate the differences between asset acquisitions and stock acquisitions, and the desire to allow acquirers to obtain a stepped-up basis in the target assets (a consequence of asset acquisitions but generally not of stock acquisitions) without actually requiring the parties to undertake the formal steps that would lead to the stepped-up basis.[138]

Like Section 338, a key purpose of the Partnership Restructuring Election proposed herein is to mitigate the differences between the various forms of partnership transactions. That purpose would be effectuated by allowing taxpayers to elect whether to impose a tax fiction for purposes of determining the tax consequences of the transaction.[139] As with the Section 338 fictions,[140] the tax consequences of the proposed Partnership

---

137. When any Section 338 election is made, two separate corporations—the "old" target corporation and the "new" target corporation—are deemed to exist for tax purposes. If an election is made under Section 338(g), the tax consequences of the transaction are determined as if both (1) the old target sold all of its assets to the new target and (2) the old target stockholders sold all of their target stock. I.R.C. § 338(a) (2000); Treas. Reg. § 1.338-1 (as amended in 2006). *See generally* 1 MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS ¶ 205 (2006) (discussing "regular" Section 338 elections). If an election is made under Section 338(h)(10), the target corporation is deemed to sell all of its assets, distribute the proceeds to its owner, and cease to exist; the formal stock sale is ignored for purposes of determining the tax consequences of the transaction. I.R.C. § 338(h)(10) (2000); Treas. Reg. § 1.338(h)(10)-1(d) (as amended in 2006). *See generally* GINSBURG & LEVIN, *supra*, at ¶ 206 (discussing Section 338(h)(10) elections).

138. *See* S. REP. NO. 97-494, at 191–97 (2d Sess. 1982), *as reprinted in* 1982 U.S.C.C.A.N. 781, 949–55; H.R. REP. NO. 97-760, at 535–40 (2d Sess. 1982) (Conf. Rep.), *as reprinted in* 1982 U.S.C.C.A.N. 1190, 1309–14. *See generally* James T. Chudy et al., *Stock Purchases Treated as Asset Acquisitions—Section 338*, 788 Tax Mgmt Portfolio, Part I.B. (discussing the legislative history behind Section 338); Raymond P. Wexler & William R. Welke, *Section 338—Consistency and Complexity*, 63 TAXES 916, 917 (1985) (discussing the background behind Section 338).

139. Note that the Section 338 election only allows a unidirectional election; it permits taxpayers to choose to treat a formal interest sale as a fictional asset sale, but does not allow taxpayers to choose to treat a formal asset sale as a fictional interest sale. In contrast, the proposed Partnership Restructuring Election proposes a multidirectional election, where a formal interest transfer can be treated as a fictional asset transfer (either assets-over or assets-up), and a formal asset transfer can be treated as a fictional interest transfer or as a different type of fictional asset transfer. *See infra* Part IV.A.2.c (discussing the check-the-box regulations as an example of a multidirectional election).

140. Given that the tax consequences that arise from a Section 338(g) election are usually unfavorable for taxpayers, except in limited situations such as certain acquisitions of foreign targets and acquisitions of domestic targets with significant and expiring net operating losses, Section 338(g) elections are rare. However, Section 338(h)(10)

Restructuring fictions can be beneficial or detrimental to taxpayers depending on their individual situations,[141] so Section 338, like the proposed Partnership Restructuring Election, leaves the choice of tax fiction to the discretion of the taxpayers. Admittedly, Section 338 applies to corporations and not partnerships. Given the many differences between Subchapter C and Subchapter K, and given some of the complicated Subchapter C issues surrounding the enactment of Section 338,[142] the analogy between Section 338 and the proposed Partnership Restructuring Election is far from perfect. Nonetheless, it is a useful example of a situation in which a taxpayer could undertake a single economic transaction in more than one form, but instead selects one particular form for the legal steps in the transaction and elects to determine the tax consequences based on the fiction of another form.

b. Section 754 Election—Adjusting Asset Basis Upon Interest Transfers and Property Distributions

Within Subchapter K, if a partnership makes a Section 754 election, the basis in partnership property is adjusted upon the sale or exchange of an interest in the partnership and upon the distribution of property out of the partnership.[143] The regulations under Section 754 (and under Sections 734 and 743, which are triggered by a Section 754 election) do not explicitly create an asset-transfer fiction like the Section 338 regulations do. However, the Section 754 election very generally shifts the tax analysis of transfers of partnership interests and distributions of partnership property away from an approach that respects the formal transactions, and toward a fictionalized approach that determines certain tax consequences of the transaction in a manner more akin to the way in which the tax consequences would be determined if the partners owned a direct interest in the partnership assets. This is essentially an election between an "entity" and "aggregate" approach to partnerships.[144]

---

elections are quite common. *See generally* GINSBURG & LEVIN, *supra* note 137, at ¶¶ 204–206; Chudy, *supra* note 138.

141. *See supra* Part II.D.

142. The effect of the *General Utilities* doctrine on corporate transactions is one example of such complications. Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200 (1935).

143. I.R.C. § 734(b) (2000 & Supp. IV 2004). Note that any adjustment to the basis of partnership property under Section 743(b) is treated as an adjustment with respect to the transferee partner only.

144. For example, if a Section 754 election is in effect, a transferee of partnership interests becomes entitled to the same aggregate basis in its share of the partnership assets as it would have had if the transferee had actually acquired direct interests in the assets. The adjustment to the asset basis accounts for the difference between the transferee partner's proportionate share of the adjusted basis of the partnership property

Similarly, the proposed Partnership Restructuring Election would allow partners in mergers and incorporations to elect whether to regard transfers of interests or whether to analyze the tax consequences of a transaction as a deemed transfer of the underlying assets (either as an assets-over fiction or an assets-up fiction). Moreover, allowing the partnership to elect an aggregate approach to mergers, divisions, and incorporations should mean that the partnership is not required to make actual distributions of the assets up out of the partnership in order to have the assets-up construct apply, since the aggregate approach to partnership already treats the partners as owning direct interests in the assets. As with Section 338 and the proposed Partnership Restructuring Election, the Section 754 election's shift to a more fictionalized approach can be beneficial or detrimental to the parties depending on the particular facts and circumstances,[145] but, subject to certain limitations,[146] taxpayers are afforded the choice of whether or not to make the Section 754 election and the resulting basis adjustments under Sections 734(b) and 743(b).

c. Check-the-Box Election—Choosing Entity Characterization

The check-the-box regulations also provide a useful comparison to the proposed Partnership Restructuring Election, both because the check-the-box regulations are an example of an explicit tax election that offers taxpayers the flexibility to choose one tax construct over another and because the check-the-box regulations are part of the larger analysis of

---

and the transferee's basis in its partnership interest. I.R.C. § 743(b) (2000 & Supp. IV 2004). However, the fiction is not fully respected, in that the allocation of the basis among the assets under Section 755 may differ from the allocation that would have been made if the transferee had acquired direct interests in the partnership assets. *See generally* MCKEE ET AL., *supra* note 16, at ¶¶ 24.01, 25.01 (discussing how Section 754 changes the analysis under Sections 743(b) and 734(b), respectively, from an entity approach to partnerships to an aggregate approach to partnerships).

145. *See generally* MCKEE ET AL., *supra* note 16, at ¶¶ 24.01-.12, 25.01-.07 (discussing the details and consequences of making a Section 754 election).

146. Basis adjustments are mandatory under Section 734 and 743 if there are substantial built-in losses. I.R.C. §§ 734(a) (requiring a Section 734(b) adjustment if "there is a substantial basis adjustment"), 743(a) (requiring a Section 743(b) adjustment if "the partnership has a substantial built-in loss immediately after [the] transfer") (2000 & Supp. IV 2004). Also, once a Section 754 election is made, revocation generally requires the approval of the Service. Treas. Reg. § 1.754-1(c) (as amended in 2000). In addition, the elective nature of Section 754 has been the subject of debate in Congress and may be changed in the future. *See* S. REP. NO. 108-192, at 188–90 (2003) (proposing that Section 754 elections be mandatory and not elective).

whether the partnership merger, division, and incorporation rules meet the goal of equitable treatment.[147] As discussed above, the check-the-box rules generally allow entities to elect whether to be taxable as a corporation or as a partnership (or disregarded entity, in the case of a wholly-owned entity),[148] regardless of the entity's default classification under the check-the-box rules,[149] and regardless of what the entity's classification would have been under the prior regulations.[150] So too does the proposed Partnership Restructuring Election contemplate that taxpayers can choose among the various tax fictions regardless of form.

Although an analogy to the check-the-box regulations may support allowing explicit elections in general, the particular treatment of partnership-to-corporation conversions under the check-the-box regulations conflicts with the way in which the proposed Partnership Restructuring Election would treat incorporations.[151] In the preamble to the check-the-box regulations, the Service explicitly rejected precisely the type of full-blown choice for incorporations proposed by the Partnership Restructuring Election.[152] Nevertheless, the rationale articulated in connection with the promulgation of the check-the-box elections actually supports allowing an elective approach, both for the check-the-box regulations themselves and as suggested in the proposed Partnership Restructuring Election. As one commentator said in connection with the proposed check-the-box elections, "the lack of choice in the [check-the-box] regulations is inconsistent with the[ir] intent."[153] Specifically, the partnership incorporation rules and certain of the limitations on the use of the assets-up construct in partnership mergers and divisions include a number of formalistic distinctions.[154] This formalism is based largely on differences in local law and other distinctions that are not particularly meaningful for tax purposes; the ability to obtain assets-up treatment should not depend on

---

147. *See supra* Part III.B.3.a.

148. Unlike the Section 338 election, the check-the-box election is multidirectional, in that entities that would otherwise be treated as corporations can elect, with some limitations, to be treated as partnerships or disregarded entities for tax purposes, and entities that would otherwise be treated as partnerships or disregarded entities can elect to be treated as corporations for tax purposes.

149. Treas. Reg. § 301.7701-3(b) (as amended in 2006) (providing default rules).

150. *See* Treas. Reg. § 301.7701-2(a)(1) (as amended in 1993) (determining whether an entity was treated as a partnership or a corporation for tax purposes using a multifactored test, which included a determination of whether the entity had continuity of life, centralized management, limited liability, and free transferability of interests).

151. *See supra* Parts II.C, III.B.3.a.

152. T.D. 8844, 1999-2 C.B. 661, 662 (rejecting commentators' recommendations "that taxpayers be allowed to choose which [construct] to apply to an elective conversion," which choice "would allow taxpayers to avoid having to take the actual steps of a conversion to produce the most favorable tax results").

153. *Id.*

154. *See supra* Parts II.A–C, III.B.1.

the type of assets held by a particular partnership and the ease with which a partnership can transfer the assets under local law pursuant to contracts and otherwise.[155] Further, as discussed herein, the regime governing the tax analysis of partnership mergers, divisions, and incorporations could be simplified,[156] thereby avoiding some of the considerable and inefficient expenditures that taxpayers might need to make in order to take the steps that would ensure the application of the desired tax construct.[157]

When faced with similar concerns in the past, where there were "increasingly formalistic" rules based on "historical differences under local law,"[158] where "legal distinctions previously drawn . . . were no longer meaningful," and where "taxpayers still were required to expend considerable resources to ensure that they obtained the classification they desired,"[159] the Service "replace[d] [the prior] rules with a much simpler approach that generally is elective [the check-the-box regulations]."[160]

---

155. *See supra* Part III.A (discussing business limitations on obtaining preferred tax treatment).

156. *See supra* Part III.B.2.

157. *See supra* Part III.A (discussing inefficiencies resulting from the current partnership merger, division, and incorporation regime).

158. T.D. 8697, 1997-1 C.B. 215, 216.

> The existing regulations for classifying business organizations as associations (which are taxable as corporations under § 7701(a)(3)) or as partnerships under § 7701(a)(2) are based on the historical differences under local law between partnerships and corporations. Treasury and the IRS believe that those rules have become increasingly formalistic. This document replaces those rules with a much simpler approach that generally is elective.

Id.

159. T.D. 8844, 1999-2 C.B. 661, 662.

> [T]he purpose of implementing the regime was to simplify an area of the law where legal distinctions previously drawn in determining an entity's classification were no longer meaningful. While the factors considered under prior law did not meaningfully distinguish between business organizations, taxpayers still were required to expend considerable resources to ensure that they obtained the classification they desired. Small business organizations often lacked the resources and expertise to achieve their desired tax classification. This was viewed as unfair. The IRS was also expending considerable resources providing guidance on these classification issues. These same concerns generally are not present in determining the form of a conversion transaction. Therefore, the final regulations maintain only one form for each type of elective conversion.

Id.

160. T.D. 8697, 1997-1 C.B. 215; *see also* Treatment of Changes in Elective Entity Classification, 62 Fed. Reg. 55,768, 55,769 (proposed Oct. 28, 1997) ("The proposed regulations provide a specific characterization for each of the four possible elective changes. In each case, the characterization provided in the proposed regulations attempts

Accordingly, it is submitted that the Service was mistaken when concluding that the concerns that motivated the adoption of the check-the-box regulations "generally are not present in determining the form of a conversion transaction."[161] It is respectfully suggested that the treatment of partnership-to-corporation check-the-box conversions be reconsidered, and that the existing check-the-box regulations not be viewed as an impediment to the adoption of the Partnership Restructuring Election proposed herein.[162]

B. Achieving Consistent Treatment for Substantively Equivalent Transactions While Furthering Other Policy Goals

By allowing partnerships to elect which tax fiction applies to a merger, division, or incorporation, the proposed Partnership Restructuring Election remedies the problem of disparate treatment discussed in Part III. Every partnership engaged in a merger, division, or incorporation would be given the same choice about tax fictions, and thus each transaction would be treated in the same manner as other like transactions, regardless of the actual form or formlessness of the transaction. Although the tax consequences of a given merger, for example, may be determined based on a different fiction than another merger if the partnerships involved in the particular mergers elect different tax fictions, each partnership can choose to implement whichever form is preferable from a business perspective, without influence or distortion of incentives based on the form's tax consequences. This choice removes the discrimination that is inherent in the current regime against certain taxpayers who, because of their type of assets, industry, regulatory limitations, financing arrangements, or other particular circumstances, cannot, without great difficulty or expense, undertake transactions in the form that would entitle them to determine their tax consequences based on the most favorable tax construct. Hence, the Partnership Restructuring Election achieves the goal of functional neutrality—impartial tax treatment among various forms for mergers, divisions, and incorporations—where the current authorities do

---

to minimize the tax consequences of the change in classification and achieve administrative simplicity.").

161. T.D. 8844, 1999-2 C.B. 661, 662.

162. Changes to the treatment of partnership-to-corporation conversions under the check-the-box regulations to allow taxpayers to elect the applicable construct might, on the basis of equity considerations, mandate similar changes to the treatment of corporation-to-partnership conversions, corporation-to-disregarded entity conversions, and disregarded entity-to-corporation conversions. *See* Treas. Reg. § 301.7701-3(g) (as amended in 2006) (prescribing tax constructs applicable to each such conversion). Alternatively, the Partnership Restructuring Election could be adopted without any change to the check-the-box regulations on the basis articulated above in Part III.B.3.a.

not. Further, under the Partnership Restructuring Election, if a formless transaction is most efficient, partnerships would no longer be forced to implement a form of transaction in order to obtain a particular tax result. Rational partnerships would no longer be incentivized to divert resources from more productive uses in order to pay for the increased business or tax costs required to achieve competing tax or business goals.

Admittedly, the goal of functional neutrality could also be achieved by adopting a single blended approach to the tax consequences of a partnership merger, division, or incorporation. Such an approach would impose a single set of rules that would override the provisions of Subchapter K regarding tax consequences of distributions and transfers, and would instead specify basis, holding period, recognition of gain, and other consequences of partnership transactions regardless of the form of the transaction. Under such a proposal, the implicit elections in the existing regimes would be eliminated, and equal treatment would be provided across the board for various forms of mergers, divisions, and incorporations. Transaction costs would be reduced under such a regime because partnerships would not need to analyze the various alternative tax analyses in order to choose (implicitly, as in the current regimes, or explicitly, under the proposed Partnership Restructuring Election) among them. However, in order to adopt such a single approach, the Service would have to choose among the current competing basis, holding period, and gain recognition rules.[163] Since it is not clear which rules produce the most favorable result for the taxpayer or the government in every situation, the choice of any single set of rules would necessarily produce favorable results for some taxpayers and unfavorable results for others depending on their particular facts and circumstances. This result is often acceptable, but in the context of partnership restructurings, it is hard to predict with any certainty which taxpayers will experience a windfall from the chosen rules (and hence might be incentivized to engage in an otherwise inefficient transaction), and which taxpayers will be deprived of the use of properly obtained tax attributes as a result of the chosen rules (and hence might refrain from engaging in otherwise efficient transactions).

Moreover, adopting a single blended approach to the analysis of the tax consequences of partnership mergers, divisions, and incorporations would be a step backward toward the assets-over regimes that were in

163. *See, e.g.*, *supra* note 60 and accompanying text.

place under Revenue Rulings 68-289 and 70-239.[164] Even though it would provide equal treatment to restructurings regardless of their form, a single blended approach would suffer from the same failure that doomed these old rulings, namely, the failure to acknowledge and respect the possibility that different tax consequences could arise from different approaches to the transactions. In contrast, the proposed Partnership Restructuring Election simultaneously acknowledges the various possible tax consequences for a given type of restructuring and provides equal treatment to the various forms of mergers, divisions, and incorporations by allowing the relevant parties to elect which construct will be employed for purposes of determining tax consequences.

Despite the Partnership Restructuring Election's equal treatment of like transactions, and although there is precedent for explicit elections both in and out of Subchapter K, the proposed Partnership Restructuring Election cannot resolve all broader equity considerations. Unless the check-the-box regulations are changed to allow taxpayers to choose the fiction applicable to the partnership-to-corporation conversion, the treatment of these federal tax classification changes will differ from the tax treatment of state law incorporations under the Partnership Restructuring Election. Although this Article suggests that the IRS ought to reconsider making the tax treatment of check-the-box conversions elective, in the absence of such a change, differential treatment of the check-the-box conversions and state law incorporations (whether formal or formless) could be justified because the check-the-box conversion is itself a fiction and, unlike state law incorporations, lacks non-tax significance. As to the authorities regarding transfers of partnership interests, the technical termination rules under Section 708 and Revenue Ruling 99-6 are inconsistent with each other.[165] Reconciling these authorities is outside the scope of this Article, but given the inconsistency, it is impossible for the treatment of partnership restructurings to be consistent with both. Nevertheless, the proposed Partnership Restructuring Election draws a little bit from each; the proposed Partnership Restructuring Election uses an assets-over default rule, which is aligned with the treatment of technical terminations, and the proposed Partnership Restructuring Election allows an interests-over fiction for partnership mergers, which is in accord with Revenue Ruling 99-6's treatment of the acquisition of all interests in a partnership by one person.

164. *See supra* note 13 (discussing the evolution of the tax treatment of partnership mergers and divisions); Rev. Rul. 70-239, 1970-1 C.B. 74 (concluding that all partnership incorporations have the same tax consequences as assets-over incorporations prior to Rev. Rul. 84-111, 1984-2 C.B. 88).

165. *See supra* Part III.B.3.b.

By expanding the use of fictions, the proposed Partnership Restructuring Election promotes flexibility. Flexibility is both an expressly stated goal of Revenue Ruling 84-111's conclusion that different incorporation constructs have different tax consequences, and, with respect to the allocation of tax burdens of partnership transactions among partners, it is "[o]ne of the principal legislative objectives of Subchapter K."[166] This increased flexibility ought not to increase the risk of abuse since the proposed Partnership Restructuring Election does not give partnerships any tax options that were not already implicitly available.[167] Rather, the election merely removes the non-tax barriers from the use of the tax constructs. Moreover, since the parties to the transaction would all be obligated to agree on and be bound by the chosen fiction, the risk of government whipsaw is not increased by this decreased emphasis on form and expanded use of fictions. Additionally, the current anti-abuse provisions would be retained for partnership mergers and divisions and expanded to cover incorporations, which would also help mitigate the risk of abuse.

The proposed Partnership Restructuring Election would be a simplifying and easily administrable change. Because there would be one default rule and because the election would only allow for three alternative constructs,[168] the rules would be relatively easy to follow. Nuanced rules about how to qualify for assets-up treatment would be removed, and taxpayers and the IRS would not have to spend time analyzing how to comply or determining whether taxpayers have complied, respectively, with the particular requirements for the different tax constructs. An election does increase the filing burden from an administrative perspective, but the filing should not be any more complicated

166. MCKEE ET AL., *supra* note 16, at ¶ 1.03 (citing H.R. REP. NO. 83-1337, at 65 (2d Sess. 1954), *as reprinted in* 1954 U.S.C.C.A.N. 4017, 4044.

167. Furthermore, Section 754 allows partnerships to elect whether or not to adjust inside basis upon the occurrence of certain events that could cause outside basis to be adjusted. I.R.C. § 754 (2000). Making or failing to make this election can be a common reason why the partnership's basis in its assets may differ from the partners' bases in their partnership interests, and hence why there might be a difference in the tax consequences depending on whether the assets-over, assets-up, or interests-over constructs apply. To the extent that making or not making the Section 754 election is the source of the disparate tax treatment, the Partnership Restructuring Election would merely afford the partnership a choice that Subchapter K has already concluded that partnerships should be allowed to make.

168. *See supra* note 127 (discussing why this Article's proposal allows for only three possible constructs).

than filings made in connection with a Section 338 election,[169] and could even be as simple as the one-page filing associated with making a check-the-box election.[170] Moreover, because there is a default rule, a filing will often not be necessary at all.

V. CONCLUSION

Ultimately, this Article's proposed Partnership Restructuring Election is an acknowledgement that various forms for mergers, divisions, and incorporations effectuate the same substantive transactions, which should, and can, be treated the same way for tax purposes. The goal of like treatment is accomplished by adopting a consistent approach to the use of fiction and form in analyzing the tax consequences of these substantively equivalent transactions. Rather than sometimes strictly adhering to form (like Revenue Ruling 84-111 with respect to incorporations), sometimes regarding purported "form" with some fictional caveats (as with the requirements for the assets-up construct in partnership mergers and divisions) and sometimes disregarding form entirely in favor of only one fiction (as with merger and division structures not meeting the assets-up or assets-over requirements), the proposed Partnership Restructuring Election lets form (or formlessness) be merely a reflection of the business needs of the parties and uses a single set of elective fictions to determine the tax consequences of the transaction. This proposal results in an increasingly prominent role for fiction in the tax analysis of partnership transactions, but justifiably so. Fiction can be an incredibly valuable tool for interpreting transactions to reflect coherent tax policy, assuming we are willing to see the truth in the lie.[171]

169. *Elections Under Section 338 for Corporations Making Qualified Stock Purchases*, I.R.S. Form 8023 (rev. Feb. 2006); *Asset Allocation Statement Under Section 338*, I.R.S. Form 8883 (Oct. 2002).

170. *Entity Classification Election*, I.R.S. Form 8832 (rev. Mar. 2007).

171. "And after all what is a lie? 'Tis but The truth in masquerade . . . ." LORD BYRON, DON JUAN 406 (T.G. Steffan et al. eds., Yale Univ. Press 1973) (1823).